

# Global expansion of electrodynawales essay sample

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



## 1. 0 INTRODUCTION:

“Corporations that have significant foreign operations must consider several factors that do not affect purely to domestic firms. These include; foreign exchange rates, different interest rates from country to country, complex accounting methods for foreign operations, foreign tax rates and the intervention from the foreign governments” (Ross Westerfield Jaffe 2004). Perhaps the most important complication of international finance is foreign exchange and the risks associated with it. Any firm having multinational operations is bound to face the foreign exchange risks and there are ways of safeguarding the organization against such risks.

With this background this report makes a case study of the foreign exchange risks being faced by the new European company ‘ElecdyneWales’ promoted by ‘Elecdyne’ a Japan based electronic manufacturing Company to cater to the EU market, suggest suitable pricing strategies especially for the EU market in respect of the company’s products that are in hot demand, analyse the relative exchange risks of importing materials/components from different countries for the manufacture and also the ways by which the company can guard itself against the exchange risk exposures that the company may have to face.

## 2. 0 ‘ELECDYNEWALES’ – A BACKGROUND:

The company Elecdyne headquartered in Japan is engaged in the manufacture of a wide range of electronic products such as televisions, Video Cassette Recorders, Digital Video Disc Players, hi-fi music systems,

MP3 players and so on. With a strategic idea of capturing the European market, the company has formed a European subsidiary company ‘ElecdyneWales’ based in South Wales. Although ElecdyneWales is situated in UK, majority of its output is exported to Germany and other European countries.

The company has ambitious plans of covering a market share of five percent of the total markets size of £150 million of Germany and £ 90 million in UK in the personal stereo segment. While the major target market remains as Germany, the company has plans to expand its sales to France and Italy in the next two years period by positioning themselves in UK. With this idea of major sales expansion, the company is contemplating to enter into an Export Distribution partnership with Deutscher Electronics in Germany. The company has also established sources of imports of components from Japan and USA and is also in the process of identifying new sources in China for certain parts.

### 3.0 ANALYSIS OF EXPOSURE RISKS:

“ A company may engage in foreign currency operations by entering directly into business transactions that are denominated in foreign currencies; the results of these transactions will need to be translated into the currency in which the company reports.”(Accounting Standards Board)

Because of its global positioning and major exports to Germany, with plans to export to other European countries in the near future, the company ElecdyneWales has subjected itself to the exchange exposure risks. The

company may have to face further exchange exposure risks because of its plans to import components from other countries like Japan, USA or China.

“ An Exposure can be defined as a Contracted, Projected or Contingent Cash Flow whose magnitude is not certain at the moment. The magnitude depends on the value of variables such as Foreign Exchange rates and Interest rates.”(Kshitij)

The exchange exposure risks can be categorized to three kinds:

- Transaction Exposure
- Translation Exposure
- Economic Exposure

#### Transaction Exposure:

“ Transaction exposure arises when a firm faces contractual cash flows that are fixed in a foreign currency. Whenever a firm has foreign-currency-denominated receivables or payables, it is subject to transaction exposure, and the eventual settlements have the potential to affect the firm’s cash flow position.”(Management of Transaction Exposure)

Thus Transaction exposure arises when a firm has already entered in to foreign exchange

Transactions on account of imports, exports, investments, loans or other transaction which entails physical flow of foreign exchange from one country to another. Generally this type of exposure results from short-term cash flows.

Translation Exposure:

“ Translational exposure is the risk of the net worth of a company changing because of the fluctuating home valuation of assets and liabilities denominated in foreign currencies. It arises from converting a multinational’s overseas subsidiaries translated from local currency to home currency prior to consolidation with the parent’s financial statements. This may include foreign currency loans and investments.”(Lecture on Currency Exposure)

Economic Exposure:

“ A firm is subject to ‘economic exposure’ if changes in exchange rates affect the firm’s value, as measured by the present value of its future cash flows.”(Richard C. Marston)“ The longer term change in value relationship between two currencies gives rise to ECONOMIC exposure. It is the most subtle and insidious of all the types of exposure, and has the potential to ruin a company, but to do it in a very surreptitious manner. It arises when it is thought that future cash flows will be affected by changing exchange rates. Economic exposure can thus be thought of as the extent to which the present value of future cash flows is affected by exchange rate movements.”(Lecture on Currency Exposure)

Distinct from Transaction exposure which occurs on short term cash flows, Economic Exposure arises from the long-term effects on the cash flow in foreign exchange. As such it is difficult to measure the economic exposure because of the complexity of its nature. The factors responsible for causing

economic exposure are deviation from purchasing power parity, relative price changes and taxation factors.

Assuming that the company, ElecdyneWales is a subsidiary of 'Elecdyne' there will be Translation exposure, resulting in the valuation of assets and liabilities of ElecdyneWales for inclusion in the financial statements of the holding company Elecdyne Japan. Also because of its foreign exchange dealings both in respect of imports and exports, the company will be facing the short-term and long-term foreign exchange exposure risks namely Transaction Exposure and Economic Exposure, for guarding against which the company should make adequate planning.

#### 4.0 EFFECT OF TRANSACTION EXPOSURE FOR ELECDYNEWALE:

“ Exchange-rate movements affect both the cash flow of a firm's operation and the discount rate employed to value these cash flows. Moreover, it is commonly believed that exchange rates are an important source of macroeconomic uncertainty that influence the performance and the value of the firm in an international context.” (Aline Muller and Willem F. C. Verschoor 2003)

Based on analysis of the cross currency rates between the British Pounds and Euro for exports and between British Pounds and Japanese Yen, Chinese Yuan and US Dollar for importing, this report analyses the relative position of the company with respect to the transaction exposure on the export and import transactions:

##### 1. Exports to Germany and other European countries:

<https://assignbuster.com/global-expansion-of-electrodynawales-essay-sample/>

There had been a tendency for the British pound to be in the verge of getting stronger against the Euro. This indicates that the British economy is booming. A continuous strong position of the Pound against Euro implies that the prospects of realizing higher export realization in terms of British Pounds appear to be less. It may also affect the sales volume the company is planning to build up for exports in to Europe. The relative positions of foreign exchange rates between Pound Sterling and Euro is exhibited in Appendix I

### 2. Importing components from Japan:

As such the company has reliable suppliers from Japan for 20GB Hard Disc, Lithium Ion Batteries, Fire Wire and USB compatible components with a reliable quality. It is advisable to continue to source these items from Japan as the British pounds against Japanese Yen is very strong and the company will derive the advantages of a favourable transaction exposure by importing from Japan. Moreover the quality of the components that can be imported from Japan can be heavily relied upon. The movements of the cross currency exchange rates between Japanese Yen and British Pounds and the average rate that can be adopted for calculations of import values is given in Appendix II

### 3. Importing components from the United States:

Even against the US dollars the British Pound is showing a stronger tendency. This implies that the company can choose the suppliers from the US as an alternative to those in Japan for Fire Wire and USB compatible components where the quality of the supplies from the US can be ensured. The 12 monthly average rates for the US Dollars against British Pounds and

the average currency exchange rate that can be adopted for valuing the imports from the US is exhibited in Appendix III

#### 4. Importing components from China:

20 GB hard disc, Fire Wire and USB compatible Component can be sourced from China, although the quality of these components from China is still not established. However from the foreign exchange point of view, sourcing these items from China will be beneficial to the company, as the British Pound is behaving the same way as it moves with the Japanese Yen and US dollars. If a reliable supply source can be established, then the company may do well to import these items from China as well. A table showing the 12 monthly cross currency exchange rates between Pound Sterling and Chinese Yuan is attached as Appendix IV.

#### Safeguarding against Transaction Exposure Risks:

The best option available to ElecdyneWales to safeguard its position with respect to the exchange fluctuations for exports is to have periodic review of the prices to assess the relative effect on the profitability of the products. The prices may be revised based on such periodical analysis.

In case the company is contemplating to enter into a contract with Deutscher Germany as a distributor, the contract should contain specific terms with regard to the currency exchange rates and the contract should identify the party who will absorb the rate exposure risks. Alternatively the parties may agree for a revision of the rates for every shipment depending on the spot rates. Similar such agreements should be entered into with the suppliers of



the components to take guard against the exchange rate exposure risks associated with the imports.

#### 5. 0 EFFECT OF ECONOMIC EXPOSURE FOR ELECDYNEWALES:

Since the company is contemplating to make large exports to Germany it is advisable to have a though understanding of the foreign exchange rates and the interest rates on the economy over a longer period. This will enable the company to guard against any unfavorable economic exposure. Considering the increase in the purchasing power of Germany, at 4% for the year 2006, and the continuous increase in the consumption development in terms of Euro for the years 2004, 2005 and 2006, it appears that the German Economy is getting stronger over the period and this trend is likely to continue for the future also, especially after the introduction of Euro, with more countries joining the EU. Moreover the per capita income at € 18000 also signifies a stronger outlook for the economy. Hence the economic exposure will be to the advantage of ElecdyneWales as the UK economy is also getting stronger which is shown by the increasing currency exchange rates between Pound and Euro.

#### 6. 0 EFFECT OF TRANSLATION EXPOSURE FOR ELECDYNEWALES :

Since the consolidated statement will be presented by Elecdyne Japan, the accounting records of ElecdyneWales may not get vitiated as the company will continue to keep its books in British Pounds only. However for converting the value of assets and liabilities, the exchange rate on the date of the final accounts will have to be taken by Elecdyne Japan.

7. 0 PRIICNG OF PRODUCTS:

Out of the several products of ElecdyneWales the new 20GB hard drive Juke Box and the micro MP3 with USB flash drive have been identified as having high potential for selling in the Europe market. Hence there is a request from the Marketing Manager to arrive at an equivalent Euro price for these two items. Let us proceed with the fixation of the Euro Price for the respective items. (Price calculations are shown inAppendix V)

Product	Price in GBP	Price in Euro for Other Europe Market	Price in Euro for Germany Market
20 GB Hard Drive Juke Box	300	467. 00	490. 00
Micro MP3 with USB Flash Drive	80	125. 00	131. 00

8. 0 HEDGING AS A MEASURE TO SAFEGUARD AGAINST EXCHANGE RISKEXPOSURES:

“ Significant changes in the international economic and political landscape have led to uncertainty regarding the direction of foreign exchange rates. This uncertainty leads to volatility and the need for an effective vehicle to hedge foreign exchange rate risk and/or interest rate changes while, at the same time, effectively ensuring a future financial position.”(John Nobile 2005)

“ Foreign exchange rate risk exposure is common to virtually all who conduct international business and/or trading. Buying and/or selling of goods or services denominated in foreign currencies can immediately expose you to foreign exchange rate risk. If a firm price is quoted ahead of time for a contract using a foreign exchange rate that is deemed appropriate at the time the quote is given, the foreign exchange rate quote may not necessarily be appropriate at the time of the actual agreement or performance of the contract. Placing a foreign exchange hedge can help to manage this foreign exchange rate risk”.(John Nobile 2005)Thus placing a foreign exchange hedge can help to manage foreign exchange rate risk.

If a company decides to take an active approach to foreign currency management, this will centre round the concept of hedging. Hedging a particular currency exposure means establishing an offsetting currency position such that whatever is lost or gained on the original currency exposure is exactly offset by a corresponding foreign exchange gain or loss on the currency hedge. Hedging can reduce the company’s volatility of cash flows because the company’s payments and receipts are not forced to fluctuate in accordance with currency movements.

This can, in the extreme, reduce the possibility of bankruptcy and therefore allow easier access to credit and lower interest payments due to lower perceived risk. Hedging should also allow for greater certainty about future receipts and payments and consequently enhanced budgetary decisions. Most hedging strategies are costly in terms of fees, premiums or the time involved.

“ If the company organises its international transactions within the company itself, it is called internal technique. It is also noted that internal techniques use methods of exposure management which are part of a firm’s regulatory financial management and do not resort to special contractual relationship outside the group of company itself.

These techniques aim to reduce or prevent exposed positions from arising. The main forms of internal techniques are netting, matching, pricing policies and asset liability management and leading and lagging.”(Article on Internal Hedging)

#### Internal Hedging Techniques:

Some of the internal hedging techniques and their relative advantages and disadvantages are discussed below:

#### Borrowing and lending:

This technique creates a synthetic forward by borrowing and lending at home and abroad. For example, a long forward foreign-exchange position is equivalent to borrowing at home, converting the proceeds to foreign exchange and investing them abroad. The converse holds for a short forward foreign-exchange position.

This technique is particularly useful when forwards, futures or swaps markets are thin-particularly for long-dated maturates.

However the disadvantage is that it utilises costly managerial resources and sometimes it may be prohibited by legal restrictions.

### Commodity hedging:

By going short on a commodity contract denominated in a foreign currency to hedge a foreign currency we can hedge a foreign exchange assets and by entering into a long commodity contract we can hedge the liability in a foreign currency.

It is safe to adopt this technique as the commodity markets are usually deep, particularly for maturities up to a year.

The disadvantage with this technique is that the price changes of commodities, in terms of home currency, may not exactly offset price changes in the asset (liability) to be hedged. This may result in a loss to the company.

### Leading and lagging:

This technique is employed by equating foreign exchange assets and liabilities by speeding up or slowing down receivables or payables.

The distinct advantage of this technique is that it avoids unnecessary hedging costs.

Sometimes it is difficult to get appropriate matches as they may not be available. This technique utilises costly managerial resources.

### Matching:

The essence of this technique is equating assets and liabilities denominated in each currency

This technique also avoids unnecessary hedging costs and in this case also there may not be appropriate matches available. (Source: Article on Internal Hedging)

#### External Hedging Techniques:

Generally the following external hedging techniques will be used by the companies to cover the exchange rate exposure risks:

##### Forward Hedge:

Forward hedge is used heavily by large corporations having multi locational operations. They arrange with the banks for the amount of currency needed at a particular point of time. The contract with the bank set the price and amount of currency to be bought and sold.

##### Money Market Hedge:

Money Market hedge is based on the future outflow exposure of the firm. The companies with excess cash flow may create a short-term deposit in foreign currency with the bank.

Similarly, the company can hedge on the money market for its receivables also, by borrowing from the banks on short-term and invest the money by converting into the desired currency. This is possible when the company is sure of receiving the foreign exchange at a fixed future date.

If the interest rate parity holds, firm would be indifferent to money market hedge or forward market hedge. Hence the decision to use money market

hedge depends on the interest rate parity. If it is advantageous to the company, then it may go in for money market hedge. Due to high transaction costs, interest rates and other opportunity costs money market hedge is not preferred by the companies.

#### Currency Option Hedge:

Currency Option hedge may be a buying call option for payables or hedging receivables with currency put option.

The buying call option technique provides right to buy a specified amount of a currency at a specified price with a specified time period. It does not obligate the owner to buy the currency. If foreign currency depreciates the option may allow the company to benefit from the lower cost of payables. This method is suitable for companies which are not certain whether there will be foreign currency payable exposure.

Hedging receivables with currency put options provides the right to sell a specified amount of a currency at a specific price within a specified time period. It does not also obligate the owner to sell the currency.

Hedging for Long-term Transaction Exposure includes long-term forward contract, currency swap and parallel loans. The long-term forward contracts are for time periods up to five years and it covers both payables and receivables. These types of contracts are commonly used for major currencies and these contracts will be beneficial for those companies that have entered into fixed price contracts.

Currency swaps is a system by which the receivable in a foreign currency can be adjusted against the payables in another foreign currency. With the help of a bank the exchange rate between the currencies are pre determined and once the currency is receive it is set off against the payable at the predetermined rate.(Source: Power Point Presentation by Prof. Jim Mallett)

#### 9. 0 CONCLUSION:

Having made a detailed analysis on the foreign exchange risk exposures of the company ElecdyneWales it may be summarized that the company has a potential transaction risk exposure in respect of its exports to Germany and other European countries as also with respect to its import of components from Japan at present and from US and China in future, if the company decides to deal with the suppliers from those countries.

Economic exposure risk is also to be addressed by the company by adopting suitable techniques of hedging to cover the long term exposure effects. In the area of pricing of the products the company may do well to adopt the average currency rates based on the past and the future expected fluctuations. When the company decides to enter into a distribution contract, it is better that the contract is specific about the rates of exchange and the resultant profit or loss to be appropriated. The company should analyse in detail the effects of the different exchange risk exposures in respect of the exports and imports and decide on the suitable hedging techniques to be employed.

#### 10. 0 RECOMMENDATIONS:



Based on the above discussions the following recommendations may be made to ElecdyneWales:

- In respect of the exports to Germany and other European Countries, the company should fix up the prices based on the average currency exchange rates for the past as well as future forecast. However there should be a review of the prices every quarter based on the actual movement of the foreign exchange rates.
- In case the company enters into any distribution agreement, it is advisable for the company to enter into a written contract with the distributor specifying how the foreign exchange difference will be treated. Alternatively both the parties can fix the prices at the prevailing exchange rates every time the shipments are made.
- As regards the imports, the company can enter into fixed rate contracts for a specified period which will cover the company against foreign exchange risks.
- In order to cover the short term transaction exposure the company may go in for commodity hedging as the risk factor is less in this method. However if proper rate contracts are established for both the imports and exports, the company would have been well protected from short term transaction exposures.
- As far as long term economic exposure coverage, the company may adopt call and put options depending on the amounts payable for imports and receivable for exports.

#### Appendix I

Currency Exchange Rates- Relative Position of British Pounds against Euro  
Graph Showing the Movement During Last 12 Months

Source: <http://www.angelfire.com/ca/finrisk/Internal.html>

4. John Nobile (2005) *Why Hedge Foreign Currency Risk*

<http://ezinearticles.com/?Why-Hedge-Foreign-Currency-Risk?&id=33036>

5. Kshitij *Foreign Exchange Risk Management Guidelines*

<http://www.kshitij.com/risk/fxmg1.shtml>

6. Lecture on Currency Exposure *Growth in Foreign Currency Exposure*

<http://accfinweb.account.strath.ac.uk/am/tml6.html>

7. Management of Transaction Exposure *Foreign Exchange Exposure and Management*

[http://highered.mcgraw-hill.com/sites/dl/free/0070912289/235906/new\\_chapter\\_13.pdf](http://highered.mcgraw-hill.com/sites/dl/free/0070912289/235906/new_chapter_13.pdf)

[com/sites/dl/free/0070912289/235906/new\\_chapter\\_13.pdf](http://highered.mcgraw-hill.com/sites/dl/free/0070912289/235906/new_chapter_13.pdf)

8. Prof. Jim Mallett *Managing Transaction Exposure* Chapter 11 [www.stetson.edu/~jmallett/fin503/ppt/lfmch11S2002.ppt](http://www.stetson.edu/~jmallett/fin503/ppt/lfmch11S2002.ppt)

9. Richard C. Marston *The Effects of Industry Structure on Economic Exposure* <http://ideas.repec.org/p/nbr/nberwo/5518.html>

10. Stephen A. Ross, Randolph W. Westerfield, Jeffrey Jaffe (2004) *Corporate Finance* Edition VII Tata Mc-Graw-Hill