Options to expand or options to contract finance essay

Finance

Real Options and Hedge Policy at Avon Products Inc. AVON1. jpg

Real Options at Avon Products Inc.

Option is a contract which creates for its owner right to buy or sell an item (that is the base of the option) at a fixed price (strike price) on or before the expiry of the option. Options are rights not obligations, it is possible not to utilize them. Real option is an " option that involves tangible assets (buildings, facilities, land, machines) and physical actions (digging, grading, construction) instead of financial instruments (bonds, CDs, shares) and cash flows." (Business Dictionary, nd) Real options are considered to be the possibility of deferring or reshaping of investments, projects or production decisions. They enable managers to react on environmental changes and provide flexibility by using techniques characteristic for financial instruments on physical items. Using real options enable companies to increase shareholders value by decreasing risk during operations. Real options can be bought or created, e. g. patents, production flexibility, rights; or they can be set up through existing competencies, like advertising, technical professionalism, brand name, market share, etc. Options have only two types (call option and put option), while real options can have various categories. In the following part I am going to present the main types of real options and try to find examples for them at Avon Products Inc.

Growth options

Growth options can be investments to Research and Development, mergers and acquisitions, and projects dependent on each other, etc. which can create growth possibility for future new products, new markets or new production processes. Growth options can be organic or inorganic. Organic options are for example expanding to new geographic areas; and inorganic options are like acquisitions. An ongoing project at Avon is to implement a worldwide Enterprise Resource Planning System (ERP) which would increase efficiency in the company. The ERP system is implemented in several stages according to geographical regions. It can result it new production processes or more efficient supply chain management, which can provide fundamentals and reserves for more dynamic growth to other geographical regions as the system would connect its global operations to each other, or growth to other market segments, to other industries (fashion or household goods). Other growth option could be to invest in online shopping facilities. As online shopping is more and more widespread customers may prefer this way of ordering to visiting a Sales Representative. In most cases consumers are not able to try samples at Representatives either and it is more complicated to use an intermediary in case of sending back the product. Furthermore the company could keep the Representatives' premium for itself. As the Beauty industry is a very competitive one it is hard to find options for mergers and acquisitions. We can talk about vertical and horizontal M&As. As Avon is a manufacturing and trading company vertical acquisitions can be made only in the direction of producing ingredients. Avon states that it has several suppliers and each of them is easy to replace. If Avon would find an ingredients manufacturer which produces very unique raw materials it would be beneficial to think about a real option. For horizontal growth we could find several examples in the history of Avon, as for geographical growth it had to decide between M&As, Greenfield investments, joint ventures, etc. In such a highly competitive industry it is essential to invest in R&D. Customers want nowadays products that: have natural ingredients, but are as effective as the chemical ones, are easy to use, have a pleasant smell and look fashionable. It is hard to suit all these requirements, consequently it is important to spend money on R&D. Avon has to use real options for R&D projects that it can stop if they are without results or postpone if more important projects need the resources. R&D projects can be the fundamental of company growth if they result in some breakthroughs or novelties that provide competitive advantage for the firm.

Options to expand or options to contract

Beauty is an ever changing concept: it is defined otherwise time by time. What is beautiful and fashionable today might not be tomorrow. It is especially true for colours or materials. Avon has to be able to start or stop projects according to customer demand. In summer for example there is an increase for sun protection products, sun creams, sun glasses, etc. but in winter they are not used at all. Or on contrary in winter there is an increased demand for skin care products, especially for hand care or facial care. In make ups as the years end is approaching more sparkling products are looked for, but in summer semi-transparent, natural make-up is used. For Christmas people like to buy beauty products as presents, like perfumes, creams, special kits; and they want special wrapping for the products as well. To sum up Avon has to be able to increase and decrease its capacity according to the actual demand.

Deferment options (timing options)

A possibility to invest can be more valuable than a prompt investment if the management can flexibly defer the project till the environmental and economic factors become more favourable, or if the management has the possibility to refuse or exit the project if the circumstances become unfavourable. This type of option can be advantageous even in case of projects with negative NPV. Avon could use this type of option by entering new markets, establishing new manufacturing plants or introducing new products. Timing is very important in all cases. For example Avon might have thought about introducing or developing some new upscale cosmetics in 2008, but as the financial crisis broke out such an option would be useful to defer it till the economic circumstances are more favourable. As I mentioned several times beauty industry is highly competitive, so Avon has to pay attention to competitors, and postpone investments according to their movements and announcements.

Options to abandon (exit options)

Exit options are used to stop producing a product or to give up a geographic area by closure of factories or stop selling products there. As I will mention it later Avon has problems with Venezuelan operations. The economy is highly inflationary and the government controls foreign exchange rates and restricts the cash outflow from the country. This causes significant losses for the company. If the situation becomes permanent and it cannot be solved with hedges the company should hold put the prospect of an exit option.

Sequencing options (staging options)

This kind of option is used in very expensive projects or investments. Instead of using the whole capital expenditure the project is divided into phases. First it is tested and if it is successful it can be introduces. Such an expensive option could be to establish a shop chain. Not only online shopping becomes more fashionable but there are growing numbers of customers seeking for shopping experience: they like to try products, to smell fragrances, to have the physical environment for shopping. Avon's European competitor, Oriflame has already some " Oriflame points" operated by Sales Representatives in cities, where other representatives can pick up their orders and customers can go in and shop. For Avon the first phase would be a feasibility study. It should contain the blueprint of the whole investment: how these shops would be operated, where should they be located, etc. If the feasibility study is approved, in the second phase the idea should be tested in some locations: in the U. S, in some European countries, but only at few places. The testing should be evaluated and developed, improved, mistakes should be fixed. Or if testing shows bad results, than the whole project should be shut down. In the last phase the whole system should be built.

Output mix options (product flexibility)

This option is used for developing flexible product parts which can have multiple uses: they can be attached to different products. This option can save for example inventory costs for the company. Avon can use this type of option by its skin care products, by using some ingredients for more creams simultaneously. Or considering cosmetics the company has some make up palettes where the palette is given, but the customer can choose which type of eye shadows, lip glosses, lip sticks she wants. The parts can be purchased independently as well: so if one eye shadow runs out the customer doesn't have to reorder the whole palette, but just that one colour. This is beneficial for the customer and the company as well. Avon can sell more, because the whole palette would be expensive, and customers consider the reorder of it more carefully than the reorder of their favourite colour.

Compound options (options on options)

Compound options contain more options where one is underlying another. Projects are often a collection of options by combining increasing values with protecting options of decreasing tendencies. The combined value can differ from the simple adjustment of the different options' values. A probable compound option could be for Avon entering the fitness and health industry. Most of its customers are health conscious, and deal with their weight issues, appearance on an everyday basis. So Avon could make a research, whether its customers would buy some drinks and pills which would contain important vitamins, minerals and trace elements, or maybe which could help to lose weight. When the results are positive, the company should contract a manufacturer to produce those pills in a small amount just for the pilot project, and if it is successful, than build further capacities. The same process could be done with some smaller exercise equipments (weights, step counter equipment, steppers, etc.) or DVDs. The company could introduce some accessories for trainings like towels, sport bags, hair band, special sport bras, etc. As this is a wholly new industry, the company has no experience in it, they cannot implement all the projects, they have to launch them step by step, one after another. For two types of options [Input mix options (process flexibility) and Operating scale options (intensity options)] I could not find any examples or probable options at Avon Products Inc. As a conclusion we can state that Avon could benefit from taking real options into its managerial instrument collection. And probably the company is aware of their advantages and is using them frequently.

Hedge Policy of AVON Products Inc.

Avon operates globally, through operations all around the world, and derives approx. 83% of its consolidated income from its operations outside of the United States. One of the most significant risks connected with Avon's international operations is that the particular local currency is used as the functional currency for most of its global operations. Because of this, changes in exchange rates may have a considerable impact on its cash flow, assets, earnings and financial position. Currencies for which the company has considerable exposures include for example the Australian dollar, Argentine peso, Brazilian real, Canadian dollar, British pound, Colombian peso, Chinese renminbi, the euro, Philippine peso, Mexican peso, Polish zloty, South Africa rand, Russian ruble, Turkish lira, Venezuelan bolívar and Ukrainian hryvnia. Time by time, the company uses risk management strategies and foreign currency hedging to decrease its exposure to fluctuations in cash flows and earnings linked to movements in FOREX rates. There is no guarantee of course that foreign currency rate changes will not have a financial unfavourable effect on its business, results of operations and financial condition. (Avon, 2011)Another risk related to Avon's international operations is the likelihood that a foreign government may inflict currency remittance restrictions. Due to the likelihood of government control over exchange rates and restrictions on taking money out of the country, the company may not be able to instantly send home money at the official exchange rate or if it decreases, the organization might have a material unfavourable effect on its business, financial condition and operations. Like in case of currency restrictions announced by the Venezuelan government in 2003 have become stricter and have impacted the ability of its Venezuelan subsidiary (Avon Venezuela) to get foreign currency at the official rate to purchase imported products. Unless the situation becomes more favourable, Avon's Venezuelan operations keep being negatively affected as it will have to get more of its foreign currency requirements from sources independent from government where the exchange rate is worse than the official rate. (Avon, 2011)Inflation is another risk linked with the company's worldwide operations. For example, Venezuela has been classified as a highly inflationary economy. Losses and gains deriving from the revaluation of the financial statements of subsidiaries in highly inflationary economies are showed in earnings. Given Venezuela's description as a highly inflationary economy and the depression of the official rate, Avon's operating profit, revenue and net income will be negatively affected in 2013 and beyond. Furthermore, there can be no guarantee that other economies in which it is present won't also become highly inflationary and its earnings will not be unfavourably affected as a result. (Avon, 2011)The overall goal of the company's financial risk management is to decrease the potential unfavourable effects from movements in foreign exchange and interest rates deriving from its business performance. It may diminish its exposure to fluctuations in cash flows related to movements in foreign exchange rates and interest rates by making counterbalancing positions through operational means and through the use of derivative financial instruments. Since Avon uses interest rate-sensitive and foreign currency rate-sensitive instruments to hedge a part of its active and forecasted transactions, it hopes that any decrease in value for the hedge instruments in general would be balanced by changes in the value of the fundamental transactions. The company doesn't enter derivative financial instruments for speculative or trading reasons, nor is it dealing with leveraged derivatives. (Avon, 2011)The company's hedges of its foreign currency exposure are not used to, and, therefore, cannot totally reduce the effect of movements in foreign exchange rates on its consolidated financial situation, results of operations and cash flows. Avon's foreign-currency financial instruments were valued at year-end to find out their sensitivity to foreign exchange rate movements. Based on its foreign exchange contracts at December 31, 2011, the effect of a theoretical 10% increase or 10% decrease in the U. S. dollar's value against its foreign exchange contracts would not cause a material potential change in cash flows, earnings or fair value. This potential change does not concern the company's fundamental foreign currency exposures. The theoretical effect was computed on the open positions using forward rates at December 31, 2011, adjusted for an assumed 10% increase or 10% decrease in the U. S. dollar's value against these hedging contracts. (Avon, 2011)As mentioned previously Avon uses interest-rate sensitive and foreign currency-rate sensitive instruments to hedge a defined part of its existing and forecasted transactions, it hopes that any loss or gain in value of the hedge instruments in general would be compensated by changes in the value of the fundamental forecasted transactions. Derivatives are recorded at their fair values in the Balance Sheet. The next table (Table 1) shows the derivative instruments at fair value outstanding at December 31, 2011: Table 1: Fair value of derivative instruments outstanding at December 31, 2011(in million $)derivatives. pngSource: AVON, 2011 p79When the company enters transactions with derivative instrument, it classifies the instrument as a fair value hedge, a net investment hedge, a cash flow hedge, or a non-hedge. The accounting for changes in fair value of a derivative instrument depends on whether it had classified and qualified it as part of a hedging transaction and further, on the type of hedging transaction. Gains or losses in the fair value of a derivative, which is classified as a fair value hedge, with the changes in the hedged liability or asset that is assignable to the hedged risk are noted in earnings. Gains or losses in the fair value of a derivative that is classified as a cash flow hedge are noted in AOCI. Gains or losses in the fair value of a derivative that is classified as a hedge of a foreign operation's net investment are noted within AOCI in foreign currency translation adjustments to the extent effective as a hedge. Gains or losses in the fair value of a derivative not classified as a hedging instrument are realized in earnings in other expense, in the Consolidated Income Statement. Realized changes in a derivative are noted on the Consolidated Cash Flows Statement consistent with the fundamental hedged item. (Avon, 2011)The company evaluates hedges, both at the starting and on a continuous basis, whether the derivatives are highly effective in counterbalancing changes in cash flows or fair values of hedged items. Highly effective is the derivative if the cumulative gains and losses in its fair value are between 85-125% of the cumulative gains or losses in the fair value of the hedged item. The ineffective amount of a derivative's gain or loss is noted net on the Consolidated Income Statement in earnings in other expense. Hedge accounting is stopped, when the company finds out that a derivative is not highly effective as a hedge. When it is likely that a hedged forecasted transaction will not happen, Avon stops hedge accounting for the affected part of the forecasted transaction, and reesteems changes in value that were accumulated in AOCI net on the Consolidated Income Statement to earnings in other expense. (Avon, 2011)Debts are subject to interest rate risk. Avon uses interest-rate swap agreements, which successfully convert to a floating interest rate the fixed rate on long-term debt, to deal with its interest rate exposure. The agreements are classified as fair value hedges. The company had interest rate swap agreements that efficiently converted approx. 74% in 2011 and 2010, of its long-term, fixed rate borrowings to a floating interest rate based on LIBOR. Its total exposure to floating interest rates was approx. 82% in 2011, and 81% in 2010. The company had interest-rate swap agreements with notional amounts totalling $1, 725 in 2011, classified as fair value hedges of fixed-rate debt. Unrealized gains were $147. 6 in 2011, and $94. 4in 2010, and were integrated within long-term debt. The company noted for these interest-rate swap agreements a net gain of $53. 2 in interest expense classified as fair value hedges during 2011, and a net gain of $66. 8 during 2010. The effect was counterbalanced on interest expense of these interest-rate swap agreements by an equal and balancing effect in interest expense on the company's fixed-rate debt. Occasionally, Avon may re-classify the hedging affiliation of a pay-variable/receive-fixed interest-rate swap agreement. When these occur, it enters into pay-fixed/receive-variable interest-rate swap agreements that are made to counterbalance the gain or loss on the re-classified contract. In 2011, the organization had interest-rate swap agreements that are not classified as hedges with notional amounts totalling $250. Unrealized losses on these agreements were immaterial in 2010 and 2011. During 2011, the company noted an immaterial net loss in other expense, net associated with these unclassified interest-rate swap agreements. There was no hedge ineffectiveness for the years 2009, 2010, 2011, connected to these interest rate swaps. (Avon, 2011)During 2007, the company became part in treasury lock agreements (the " locks") with notional amounts totalling $500. 0 and expiry date of July 31, 2008. The locks were classified as cash flow hedges of the expected interest payments on $250. 0 of the 2013 Notes and $250. 0 of the 2018 Notes. $38. 0 losses on the locks were noted in AOCI. $19. 2 losses are being amortized to interest expense over five years and $18. 8 losses are being amortized over ten years. During 2005, Avon became part in treasury lock agreements that it classified as cash flow hedges and used to hedge exposure to a probable increase in interest rates before the expected issuance of ten- and 30-year bonds. In December 2005, the company decided that a more proper strategy was to issue 5-year bonds given its strong cash flow and high level of cash and cash equivalents. Consequently the company de-designated the locks as hedges and reclassified the gain of $2. 5 on the locks from AOCI to other expense, net. A the same time Avon became part in a treasury lock agreement with a notional amount of $250. 0 classified as a cash flow hedge of the $500. 0 amount of five-year notes payable issued in January 2006. The loss on the 2005 lock agreement of $1. 9 was showed in AOCI and is being amortized to interest expense over five years. During 2003, the company became part in treasury lock agreements that it classified as cash flow hedges and used to hedge the exposure to the probable increase in interest rates before the issue of the 4. 625% Notes. The loss of $2. 6 was noted in AOCI and is being amortized to interest expense over ten years. (Avon, 2011)To sum up we can point out that hedging plays an important role in everyday financial transactions at Avon. As most of its sales are generated outside its home country, financial and operational risk caused by foreign exchange rate changes are high. By choosing the right location for new subsidiaries not only the wages and the distance should be considered as the most important factors: as we can see at the Venezuelan operations high inflation and the high governmental influence on economy cause more losses than the company can gain on other factors. Avon should be more cautious in the future about entering new markets and choosing the foreign locations after examining the political, economic and currency exchange situations of the given country as well. The company not only uses hedging techniques in connection with foreign exchange rates but related to bonds, notes and liabilities as well. The company values its hedged instruments regularly, and determines their efficiency. If the derivative is not highly effective the company stops its hedging activity for the given instrument. That’s how the company can be really up-to-date and correct its mistakes. At the end of the project I am going to evaluate the probability of bankruptcy at Avon. Table 2 shows the results of different models. Table 2: Bankruptcy modelsbankruptcy. pngSource: Own calculation based on Avon's Annual ReportsAccording to Altman Z-Score the company is prompt payer as the numbers are more than 2. 99 in all five examined years. Although we can see that the numbers are decreasing since 2008. The Modified Altman Z-score shows us the same results, except in 2010 and 2011 the company slipped into the grey zone, but still is was in the upper part of it. The Conan-Holder Model shows us a worse picture; according to these results the probability of bankruptcy was more than 90% for all 5 years. According to the Springate Model the company is a prompt payer, but again its solvency decreases from 2008. The Modified Springate Model shows that the company is solvent. According to the Fulmer Model the company is a prompt payer, and the Modified Fulmer Model refers to the same result. The Zmijewski Model leads us to the conclusion that the company probably goes bankrupt and the CA-score shows the same. To sum up, from them examined models the following ones said, that the company is a prompt payer and has no problems with solvency: Altman Z-score, Modified Altman Z-score, Springate Model, Modified Springate Model, Fulmer Model, and the Modified Fulmer Model. The other models (Conan-Holder Model, Zmijewski Model and CA-score) the company probably goes bankrupt. We can conclude from these results that in case of examining the probability whether a company goes bankrupt or not we cannot rely on one particular model. According to the company's size, its history and most of the models' results I would say that the company won't go bankrupt at least in the foreseeable future.