Daimlers exchange risk management management essay

While I was reading a pile of internet documents for my case, European Union was discussing the option of giving a credit to Greece in order to save the country from the bankruptcy. The negative events in European economy affected the euro. On the one hand depreciation of euro is a bad sign for the European economy, but on the other hand it gives advantages to local manufactures to produce cheaper products and be competitive in local markets. The investors all over the world worry about euro/dollar relationship? In 2006 Deloitte Development LLC[3] published a research study where it was stated that dollar would continue to depreciate against a broad list of currencies for a long-term period. However, it is not true for the current period. Nowadays all opinions regarding long-term euro/dollar exchange rate relationships look like crystal ball predictions. Does it mean that we should believe more fatalists than economists? How is it possible to hedge against exchange rate fluctuation without proper forecasts?

EURO-USD BATTLE

Most developing countries and emerging markets depend on euro or dollar exchange rate. For example, China refers to the country of a restricted exchange rate as during the long period Yuan is directly linked to the dollar exchange rate.

Starting from the introduction of euro in 2002 Europeans suffered mostly from the high value of euro. Year 2008 was not an exception as the euro appreciated by 11. 4% against the U. S. dollar and by 8% against the Chinese Yuan. In 2009 the dollar considerably appreciated against the euro but then dropped for several months and appreciated again in December.

In March 2010 Greece problems put situation upside down. Dollar again appreciated against euro. Besides, in 2010 the first signs of US recovery appeared: unemployment reduction, housing improvement, increase of consumption, stores inventory replenishment, etc. Unless the banking system again suffers a serious crisis, there will be plenty of credit available in 2010. Experts predict that two things could prevent the full recovery for both economies: a second banking crisis or bad control of interest rates.

During the last decade the FX management became one of the most important issues for the international companies. The car manufacturing industry is the best illustration of exchange rate fluctuation impact. During the last decade Euro-USD exchange rate has been changing dramatically and if the company is not able to mitigate its financial exposure it could be easily out of the industry as it could happen to Toyota in 2008. The appreciation of the yen against dollar accounted for most of the decrease of ¥262. 9 billion in operating income of Toyota. [4]

INDUSTRY

Despite all the measures taken by car manufactures most companies has announced either losses or profit decrease during 2008-2009. According to the 2009 annual report of ACEA (European Automobile manufactures association) total vehicle production in Europe decreased by 17. 3% compared to 2008 and by 23% compared to the pre-crisis level of 2007, and the passenger car production dropped by 13% to 13. 4 million units and it is the lowest level in fourteen years. [5]

In 2009 European carmakers were under extreme pressure because of the collapse in consumer demand. [6] In 2009 Daimler sold 1. 6 million cars in comparison to 2. 1 million of the year 2008.[7] Revenue decreased by 20% to 78. 9 billion euro. Daimler group declared net loss for the year 2009 of 2. 6 billion due to the high losses in the first half of the year. The main reason was a severe impact of the crisis on the automotive industry. BMW performed better than Daimler with 1. 29 million vehicle sales. Porsche sold 75, 238 cars in 2009[8] and it will stop manufacturing at its main sports car plant near Stuttgart for 18 days by the end of the year building 2, 500 fewer cars. [9]

For most of the companies the considerable part of the loss was also associated with the currency fluctuation. The car industry is the best illustration of the exchange rate risk battle in the international arena. Carmakers are finding their own way to resolve the problem of exchange risk fluctuation.

In 2007 European carmakers incurred huge losses because of the rising euro. They used to pay for parts and labor in Euros to build cars they export to the United States or other countries where customers pay in dollars or other currencies. [10]If the dollar depreciates manufacturers that do not hedge currency risks will get less revenue for each dollar sale.

Manufactures has adjusted to this situation in several ways:

1. Carmakers increased the dollar prices in order to mitigate exchange rate losses. But this move was not effective as it would lead to the slump in demand.

2. Financial hedging became very common for the most manufactures all over the world.
3. Some of carmakers have moved their facilities to foreign countries in order to satisfy local demand as everything starting from labour and transportation will be in local currency. In order to mitigate currency risks and use resources more efficiently most car manufacturing companies use so-called “ natural hedging ” or “ operational hedging” which means that the currency fluctuation is eliminated by the supply chain reallocation. The most successful ones in this field are BMW & Mercedes-Benz as they transferred manufacturing to the US. Toyota is still on the road but it has already announced losses because of the fluctuation of the yen/dollar exchange rate.

In 2009 carmakers faced another situation of euro depreciation against dollar, and at the first sight it was very favorable to them – euro started to decrease thus creating competitive advantages. But what if all cash flows were hedged considering the prediction of further depreciation of the dollar?

ACEA forecasts that 2010 will be a very challenging year for the car industry, passenger car sales are expected to go down, most notably in countries where fleet renewal schemes have ended. Considering the fact that economic downturn will go further, the car makers will do their best to cut costs as well as to keep their skilled workforce and maintain investments in R&D. In the EU 2. 2 million workers are directly employed in car industry and an additional 9. 8 million work in closely related sectors.[11]

HISTORY OF DAIMLER[12]

“ Mercedes-Benz is the most valued and best-known premium automotive brand in the world,” said Dieter Zetsche, Chief Executive of Daimler and Head of Mercedes, while giving an interview at F1 competition. “ This brand looks for competition of the utmost quality in all relevant fields in order to continually improve its performance in the face of such new challenges.”

This season Daimler has made one of Grand Prix racing more fascinating by creating the Mercedes Grand Prix team and its Silver Arrow cars and, the most important, by persuading the most successful F1 driver, Michael Schumacher, to return after three years in retirement and to race for this new German dream team. [13]

For most consumers of the world Mercedes-Benz brand has become the symbol of speed, quality and a luxurious lifestyle. The history of Daimler goes back to the mid-1880s when two engineers Carl Benz and Gottlieb Daimler, who lived 60 miles from each other, created two companies Benz & Companies and Daimler. Benz built his first automobile with gasoline engine in 1885 and started production in 1887. Daimler designed a gasoline engine in 1883 and received a German patent for a three-wheeled gasoline vehicle in 1885. Both engineers were passionate about vehicles with internal combustion engine. In 1926 the companies merged and Daimler-Benz Aktiengesellschaft was founded. Owing to this merge both companies were saved from bankruptcy during post-war years.

Since then the company passed through many transformations, crisis and successes. In 1950s Daimler-Benz became the fifth largest automobile manufacture in the world owing to acquisition of 80% of Auto Union GMbH with Audi line, which was later sold to Volkswagenwerk AG. By 1960 Daimler-Benz already had 83, 000 employees in seven West German plants. Additional assembly lines were built in Argentina, Brazil, and India, in Mexico, South Africa, Belgium, and Ireland.

In 1980s Daimler-Benz was less vulnerable to slumps in demand because target audience of the company consisted of wealthy people who were not affected by inflation, tax rates and unemployment. But during the mid 1980-s the growing segment of luxury cars made competition very intense and at this time Daimler- Benz decided to diversify and buy Motoren-und Turbinen-Union which made aircraft engines and diesel motors for tanks and ships.

In 1998 Daimler merged with Chrysler but business was not successful, and on May 14, 2007 DaimlerChrysler announced that it would sell Chrysler to Cerberus Capital Management of New York.

Now Daimler AG is a huge German automobile manufacturer. Daimler manufactures Mercedes-Benz Cars, Daimler Trucks, Mercedes-Benz Vans and Daimler Buses and provides Daimler with financial services. Mercedes-Benz vehicles are also manufactured or assembled in Argentina, Austria, Bosnia and Herzegovina, Canada, Egypt, Ghana, Hungary, India, Indonesia, Iran, Malaysia, Mexico, Nigeria, South Africa, South Korea, Thailand, Turkey, United Kingdom and USA.

In 2009 the 46% of Daimler's sales revenue came from the sales in Western Europe and 21% – from the sales in the United States. The company also owns major stakes in Japanese truck maker Mitsubishi Fuso Truck, Bus

Corporation aerospace, and group EADS, high-technology and parent company of the Vodafone McLaren Mercedes racing team of McLaren Group. [14]

Nowadays Daimler is on the road to recovery from the crisis. The luxury carmaker's CEO, Dieter Zetsche, said that he expected his company to perform better next year as it left behind disastrous sales figures of 2009. [15]

TRANSACTION AND CURRENCY EXCHANGE RISK[16]

The global nature of Daimler business exposes the company to a huge amount of risks: raw-material prices, transaction risks, credit risks and currency fluctuation risks. According to the 2009 annual report the fluctuation risk occurs when there is a considerable fluctuation between US dollar, other currencies and the euro. Daimler consolidates all financial figures in euro. The primary transaction risk arises when revenue currency differs from the cost currency. So, the revenue in a particular currency should be offset by the costs in the same currency. This natural hedging eliminates currency exchange risks. Only unmatched amount should be hedged. The huge portion of such kind of risk refers to the activity of Mercedes-Benz Car division, because huge sales are made in foreign currencies but the production cost is in euro.

Daimler mitigates significant exchange risks by refinancing receivables denominated in foreign currency related to the invested liquidity in the same foreign currency. As for the payables in foreign currency that result from company refinancing Daimler uses different derivatives, mainly foreign exchange forwards and currency option, to hedge against currency risk.

For future transactions Daimler has special internal procedures for hedging. Daimler’s Foreign Exchange Committee is in charge of managing exchange risk of the Daimler Group. The committee consists of Chief Financial Officer, the head of the Investor Relations & Treasury department, the head of the Corporate Controlling department and the heads of the Controlling departments. First, Daimler determines the exchange risk exposure by using VaR analysis which was recommended by the Bank of International Settlements. Daimler determines the value at risk for exchange rate, interest rates and equity prices by predicting the maximum loss over a certain period.

The targeted hedge ratios are indicated by the reference model which protects Daimler from unfavorable moves at currency exchange market. Hedging horizon is determined by future cash flows and the availability of appropriate currency contracts. The committee determines the average hedge ratio and hedge horizon which varies from one to three years based on the market outlook and the reference model. At the end of year 2009 the unhedged ratio was 30% while at the end of year 2008 it was only 12%.

Daimler’s internal guidelines oblige to use a mixture of derivatives depending on the view of market conditions.

Daimler consolidates all financial figures in euro: income, expenses, liabilities and assets located in foreign countries are converted to euro. That is why the fluctuation in exchange rates could significantly impact the revenue, earnings before tax and net profit of Daimler. This is called exchange rate transaction and it does not have an effect on the future cash flows.

Note of year 2009 annual report of Daimler states that in 2009, 2008 and 2007 currency fluctuations negatively affected our operating results.

Daimler hedged most of the risks arising from fluctuations in currency exchange rates during the year 2010 with the use of suitable financial instruments. For the US dollar and the British pound the hedging ratio is 60% while for the Japanese yen it is even higher.

Questions:

(1) If the dollar rate continues to appreciate against euro what kind of hedging strategy will be the most efficient one?

1. (2) When should be financial hedging and natural hedging implemented?

SOLUTION

The theory states that we should first determine risks and then hedge against them. But the life states its own rules. Years 2008-2009 showed us that it is not so simple. Financial hedging could be very expensive if a company makes wrong predictions.

If the dollar continues to depreciate and considering that the Daimler’s 2010 hedging ratio is 60% and hedging horizon is between one and three years, we can say that Daimler is exposed to additional risks related to the wrong forecasts. Moreover, we can suppose that Daimler could make wrong predictions and, as a result, inefficiently hedged at the end of 2009 or the beginning of the 2010 when the general tendency was towards depreciation of dollar.

So, we can say that for a long-term period a company should strive to maximize natural hedging. This means that revenue and costs should be accumulated in the same currency. As for the financial hedging, it is more or less efficient for up to one-year period.

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