Management practices employed by multinationals in controlling and managing the f...

Business, Management

ABSTRACT

This study seeks to highlight the management practices employed by multinationals in controlling and managing the financial risks they are exposed to. It also assessed the management practices used by multinationals in the face of financial crisis using Lufthansa and BMW ascase study.

INTRODUCTION:

Early learning of scholars has presented arguments that exchange risks have little impact on foreign activities especially by Multinationals. This view has been shared by Jorion (1991) who went on to question the activeness of financial managers who perform hedging as the risk associated with foreign exchange/currency exposure is minimal. This was also in line with the argument by Bodnar and Gentry (1993) who suggested that not many industries are faced by exchange risks depending on their significance.

However, contrary to these views, recent studies have identified exchange rate to be of huge significance amongst the risks that multinationals face and thus questioned the measurement techniques used by earlier studies. This view is supported by Doukas et al (2001) who projected that organizations who engage in foreign activities will be more affected by exchange rate movement. Eitemal et al (2006) further explain that corporate organizations, mostly multinationals face a higher exchange risk exposure than their non-multinationals counterparts because of their higher degree of international business operations.

In line of these contrasting views, the author however argues that firms wanting to exercise their international or global presence will be faced with distinctive financial management challenges. And as long as there is movement of capital andfinanceowed to the rapid movement ofglobalization, corporate organizations will continually be faced by global factors like reactions to movements in currency markets (such as a undervaluing of a currency) .

Dominguez et al (2001) go further to argue that even emerging markets are likely to be faced with a significant level of financial risk exposure as they may be relatively less efficient and for the reason that both developing and developed countries are open to such risks. Therefore, firms must be flexible in their approach by demonstrating an ability to diversify their consumers, contractors and financial sources.

IMPACT OF GLOBALIZATION

BMW: CORPORATE OVERVIEW

BMW, an independent German automobile and engine manufacturing company is a global leader in premium car sales and is known for its performance and luxury vehicles. It has under its ownership the Mini brand, BMW motorcycles and the Rolls-Royce motor cars. A commanding international company with presence in over 120 countries, the BMW Group has business activities broken down into manufacturing, assembly and sales of automobiles and a financial services arm whose primary aim is to provide financial credit to dealers and customers. Its strategic investors make up 46% of its shareholdings, while institutionalized investors breakdown include

North America 15. 8%, United Kingdom and Ireland: 11. 8%, Other Europe: 5. 7%, Germany: 4. 8%, Rest of the world: 2. 5%. Other investors make up the rest with 12. 7%.

Its financial arm provides financial and investment advice to customers and dealers alike which extends into offering financial credit which is used in the lease or purchase of its automobiles or spare parts. It therefore offers flexible and attractive payment options which also ensure that its finances circulate within the group. BMW has been to known to practice operational flexibility in a bid to handle foreign exchange shocks and has began exploration of emerging countries like China for investments and long-term commitment for service.

Establishment and entrenchment of BMW in emerging markets has emerged and identified by its operations in China for instance. China is currently its fourth largest market with huge potential even though representing only 5% has been boosted by the Chinese government offering incentives and subsidies to urge purchases.

LUFTHANSA: CORPORATE OVERVIEW

Deutsche Lufthansa AG (Aviation Group) is an international aviation company with strategic business segments providing mobility and services for airlines. A German based company serving more than 500 destinations across the world with code sharing agreements. Its business operation is segmented into passenger airline services, MRO (maintenance, repair and overhaul), provision of IT services, logistics and catering for its own airlines and extensively to external customers. However, providing passenger airline services is the hub of its business activity. It is a premium brand with global service offering via a fleet of over 500 aircrafts (which makes the company very liquid) with its major target market being Europe, America and Asia.

Lufthansa is one of the leaders in the provision of maintenance and overhaul services for external airlines, servicing government, organizations and leasing companies. It also extends this service to its own airlines. Its catering segment also provide airline cuisine as it is located at international airports of over 40 countries catering to regular customers and international airlines. Its Europe segment contributes the highest of the company’s total revenues, with sizeable contribution in North America, Asia/Pacific and the Middle East. However, it continues to strive given the significant exposure in competitive markets like Europe visible through the improvement of the flights and other business operations in Asia, North America and the Middle East. Even at this, a successful diversification of its flights to other market regions to reduce the economic, political and geographical risks has not been fully achieved.

FINANCIAL AND EXCHANGE RISKS EVALUATION

Extending operations into a global landscape is becoming increasingly challenging even as companies wish to exert global presence, they are increasingly faced by the risks that expose the unpredictability of cash flow. They are constantly faced with emerging dimensions of risks varying from long run against short run investment risks, certain against uncertain transaction risks, and risks relating to value of cash flows. Multinational corporations like BMW and Lufthansa are therefore faced with risks such as transaction risks which identifies the impact on exchange rate changes on the value of cash flows that lie in the future that has been committed but whose nominal value is known. It refers to committed transactions for which the company is expecting receivables or payables from export or import contracts. Profits or losses may arise if exchange rates fluctuate between the date of purchase and the date of payment.

They may also be faced with economic risks which refer to varying cash flows based on the impact of changes in macroeconomic activities such as inflation, economic growth and or interest rates. Inflation generally increases the cost price of goods due to an increase in costs of input which may lead to a cut back in purchases. Economic growth on the other hand may increase the demand of a product as people may increase their purchase or consumption at these periods.

Another major risk faced by MNCs such as the companies under study is translation risk which refers to the degree of influence of foreign exchange rates on the value of foreign assets and liabilities. The seeming liability for multinational companies facing translation risks is the volatility of the currency at hand and the currency with which it is being measured against.

Even as the risks mentioned above account for the major risks that multinational organizations may face, they may also be faced with some other types of risks. Country risk refers to risks that are associated with particular countries which make them higher volatility for investments. A proper country risk analysis will ensure that a corporate organization will monitor countries with excessive risk and therefore avoid entrance into such country. Government laws or bans on certain items may also have an impact on the sale of certain products while interest rates, inflation and exchange rates all have an impact on the other therefore making the consideration of entry into a country more complex. It is also pertinent to recognise that there may be political influence in some countries arising so that local companies may thrive in the face of foreign competition.

Therefore, considering the nature of globalization, even though it has encouraged borderless trading, multinational corporations have to recognise the risks associated with operating in a host country.

RISKS PECULIARITY: BMW

The BMW group enjoys the exclusivity of three premium brands that are not overlapping and doing well independently. With a keen focus on research and development, it has developed innovative display in the manufacturing of groundbreaking engines. It has therefore enjoyed success due to its unique designs and a carving a niche for itself in the luxury brand sector. However, due to its setup and base mainly in Germany, cost competitiveness may continually be a worry given that more competitors are recognising the cost advantage of emerging markets and therefore shifting their production activities to these locations. It must therefore locate a balance between cost efficiency and the status it derives from the German engineering quality.

BMW, having a huge base in Germany may pose a risk as there may be considerable currency fluctuation in other countries of operation which may result in uncertainty in cash flows. Selling to its American market may result in converting the Dollar revenue to Euros for instance, and a decline or a weakening of the Dollar makes the expected Euro income equivalence to be lower. It also faces cross-border purchases which consumers may engage in to avoid some costs mainly on currency value differences with people going to Canada for instance to purchase an automobile and driving it back into the US. These fluctuations are beyond the company's control and may on only react to the changes which may have been caused by changes in the economic position of such country, speculation, demand and supply factors on currencies, consumer index, foreign investment and or Gross National Income (GNI).

BMW also faces the risks of specification given the nature of the product it sells. Product specifications especially for countries outside Europe will be a huge concern as it may require new production lines to cater for this change. Also, risks associated with late delivery of goods or damages while shipping as was the reported case of a sunken ship containing BMW automobiles many of which were beyond repairs. Being a premium brand, BMW has to contend with high cost of producing its high quality parts and still staying within the reach of consumers who are now more exposed to cost effective automobiles given the rising of oil prices.

RISKS PECULIARITY: LUFTHANSA

Risks associating with the airline industry are becoming more complex even as the industry is becoming more competitive. The business model applicable in the industry attracts a lot of capital, labour andtechnologyinput. Additional business dynamics like increase in oil prices, frequent risk ofterrorism, charges that are specific to countries, unfavourable weather conditions and disruption of air-traffic are all risks associated with security and safety, hazards issues and operational risks that have characterised the airline industry. A peculiar situation was the abnormal weather in December 2010 which had a huge impact on air traffic as over 4, 000 flights were cancelled.

The industry is also characterised by cyclic demand, domestic and international competition which is growing by the day, increasing gearing levels, regulatory hindrance like landing rights or ownership restrictions. The concern of interest rate is particularly of great significance to airlines as it affects their debt financing. Also, the debt-to-equity ratio of the airline industry is thus equally high as it is capital intensive which makes borrowing more difficult. Bartram (2002) highlighted this further by pointing out the impact of interest rate and the succession of business cycle considering the effects on demand by customers. Carter et al (2002) also argued that due to expected costs of distress, there is a considerable level of underinvestment. When airlines are strained and therefore resort to sell off their fleet of aircraft, this may be a representation of financial distress as the aircrafts are sold off at heavily discounted amounts.

The industry is equally faced with currency risks which may affect international or domestic demand in relation to the home country currency value. For instance, if the Canadian dollar depreciates, there will be an increase in demand for flights into and within Canada by non-residents while the residents may substitute local travels for international locations. The predictability of these currency changes being close to impossible equally makes the airline operators more exposed to these risks.

A considerable contribution of airline operating cost is the cost of jet fuel which also poses a risk to Lufthansa. Although, the level of profit responsiveness may be dragging as airline tickets are sold in advance, future commitment to advertised lower fares in the short term. However, in the medium/long term its profitability decreases in relation to direct and indirect cost of fuel. Carter et al (2002) further illustrate that airlines are in a dilemma of underinvestment whenever a revenue generation opportunity presents itself during the periods of high cost of jet fuel. The further weight of the air traffic tax adopted in Germany and Austria for instance means that fuel costs cannot be passed on in full to consumers due to the sensitivity of pricing.

FINANCIAL/MARKETING STRATEGIES TO MANAGE RISKS

For BMW, recognition of the potentials of emerging markets both for demand and production units has helped diversify its risk. Its focus traditionally had been on European market, but with the steady growth of the Chinese automobile industry, there was a need to break its unilateral brand structure and embrace innovation. However, completion is becoming strife in the Chinese region as competitors have recognised the potentials it offers and focus is shifting gradually away from product competition to a comprehensive demand for brand and services. Adopting localised sustainable development in the Chinese market by adding traditional local elements will also attract demand within this newly acquired market.

Also, BMW may choose to relocate its manufacturing and supply units to final markets whose currencies are less prone to currency exchange risks. This can be done through an investment in localised procurement and production units. Shifting its base to final markets and having its suppliers do likewise ensures that BMW is guaranteed input cost safety. Whilst doing this, it can also assure its suppliers of sustainable income which reduces their vulnerability in time of fluctuations. Even as it tries to satisfy global appeal by developing unified product models, BMW cuts costs and alleviates risks by adopting flexible means of customizing its models to fit regional tastes in markets representing huge demands on short notice. For instance, it developed a longer version of one of its models solely for Chinese customers due to high demand. It can then focus supply of its marketing plans and products to markets with stronger currencies with less likelihood for fluctuations.

As the largest market outside Europe, the US plays a vital position in BMW's business plans as it established production lines for its 3 and 5 series models in the country due to increasing demand. Even at the point of establishing the plant, most of its cars were manufactured in Europe and transported to the US and sales of the cars may become more profitable as the dollar weakens. It then may build its competence to identify and take advantage of a strong currency market. It is also striving to ensure there is a plant in china by 2012, thus making sure most of its costs are denominated in local currencies.

However, all these strategies are not as expedient as currency hedging. Hedging refers to an investment that is made in order to alleviate the risk of adverse price movement in an asset. Exchange rate risk can also be neutralised (“ hedged”) through financial instruments, such as exchange rate derivatives or foreign currency debt (financial hedges), as well as through the operational setup of the exporting firm (operational hedges). Financial derivatives have today become standard tools for hedging risks related to exchange rates, interest rates or commodities prices. Accordingly, Bartram et al (2009) further argued that organizations do not only use financial derivatives, but operational hedging and foreign currency debt may be crucial to their management of financial risk.

Even as the hedging strategy may be applicable to Lufthansa AG as well, it can be argued in accordance to the views of Kim et al (1993) that diversification is considered to be a chief instrument which corporations can adopt in order to manage the financial risks facing them. This is in line with the view of the author as hedging is still a rather speculative attribute and can still lead to a loss or a profit. It can be further argued that a business ought not to fully hedge all of its firm value from all risks because when future hedges are applied and the prices go up in the first few years, there will be a large marginal impact on the cumulative futures covering the multiple years. And as a form of international strategy, Lufthansa formed the Star Alliance with other airlines which afforded it an almost faultless network of intercontinental connections which provided it with the needed expansion. Lufthansa also hedges fuel prices to deal with fuel price risk for a time sphere of two years mostly by means of time combined options. The hedging transactions are based on fixed rules and map the average of crude oil prices over time.

Sales of international tickets, fuel purchases, aircraft and spare part maintenance also present some form of currency risk to Lufthansa and it performs hedging on the main currencies it uses which are the US Dollar, the Yen, Euro and the Sterling. Being a very liquid company (Lufthansa owns about 75% of its fleet of aircrafts), considering its financial strength, Lufthansa is considered a worthy partner by investors and banks. Thus, future investment plans can be met through borrowing at an already determined action plan and the duration of such investment is limited to one year.

The risks and opportunities facing the group, is defined mainly by macroeconomic factors and a resulting effects on passenger and cargo demand. In this regard, Lufthansa relies on its capability to regulate its resources and capacity in a flexible manner in order to adapt to changing market conditions and therefore cut costs.

CONCLUSION

Organizations are faced with financial risks arising from a combination of sources either from an exposure to changes in market prices either through interest rate or exchange rate fluctuations and/or financial risks emerging from an interaction with suppliers or customers. Given that corporate risk management can lower the present value of bankruptcy and financial distress costs, firms with a high probability of default and/or high financial distress costs should be more likely to engage in corporate hedging.

Companies with international supply chains and international markets will face not only exchange rate risk from the financial accounting perspective, but risks to their competitive positions and cost-revenue dynamics as a result of steep and large declines in the dollar’s value. Financial hedging strategies are suitable for mitigating small and short-term currency fluctuations. But to avoid the effects of huge, long-term shifts in a currency’s value, the likes of BMW and Lufthansa are however advised to adopt operational hedging strategies. These provide the flexibility to dynamically manage supply chains and markets, thereby allowing some degree of difference and efficient management of the cost-revenue equation as international macro-economic forces influence the global marketplace.

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