Situation and financial results

Economics, Financial Markets

ASSIGN BUSTER

EADS is a company in aerospace industry that earns in euro but spends in dollar. This assignment is aimed to analyze its hedge situation and financial results thus make a decision for investment. Three sections as follows will illustrate the problem. 1. Risk exposure According to the registration document for EADS (2010: 95), more than 60% of the revenue is US dollars with half naturally hedged by US dollar-dominated cost. The remainder cost is mainly incurred by euro. A strong US currency will benefit EADS a lot. Thus the main risk it exposed to is exchange rate risk and credit risk.

For the portion that is naturally hedged (nearly 30% of total revenue), the exchange gain or loss from revenue and cost will partially offset one another, there seems no risk. For the portion that is covered by cash flow hedge, it is protected by forward or option to transfer US dollar to euro at a fixed rate. On the one hand, the future price will fluctuate due to different maturity and size of contracts.

Take recent two years as the example, revenue was accounted for at 1. 35US$/ï¿½ in 2010, compared to 1. 26 US$/ in 2009. This led to nearl 1 billion (18. 5/1. 35-18. 5/1. 26=-1) decrease in EBIT from 2009 to 2010. An appreciation in euro against US dollar will make the financial result worse since after translation euro revenue will be less with the same amount of US revenue. On the other hand, the credit risk of its hedging counterparties is a problem deserves concerning. The company has witnessed a hedge rate deterioration as the unfavorable appreciation trend in euro against US dollar (registration document 2010: 8). The non-performance of these counterparties will pressurize EADS to significant exchange rate risk again.

EADS's cash flow hedge covers $18. 5billion and $16. 5billion revenues in 2010 and 2009 respectively. Without this hedge the difference in euro profit will be 0. 1 billion (18. 5/1. 34-18. 5/1. 35= 0. 1) and -1. 64 billion (16. 5/1. 44-16. 5/1. 26=-1. 64). Hence the company can earn more without hedge in 2010. It can be concluded that EADS is a risk-averse company even with the sacrifice of earnings.

Accounting for hedges EADS use cash flow hedge and fair value method is used. When recognition, the one with positive value are recorded as financial asset and negative value recorded in financial liabilities. For subsequent measurement, the company needs to account for change in fair value. First of all, the effectiveness of the hedge needs to be determined. The effectiveness is defined as how much percentage change in underlying asset is covered by the change in derivative. According to IAS39, a range from 80% to 125% is regarded as effective. This portion is recorded in other comprehensive income to reflect marked to market price.

Accordingly, the negative amount of 2, 983 means the fair value of these financial instruments is decreased. Given the ï¿½45, 442m sales forward contract, a hedge rate from 1. 35US$/ in 2010 to 1. 26 US$/will result in -3, 200 (45, 442*1. 34/1. 35-45, 442*1. 34/1. 26=-3, 200) change in fair value of the contracts, which accounts for a large part of 2983. The effective portion is a hiding profit/loss that will be realized when forecasted sales happen. So -201m net change in fair value of cash flow hedged is transferred to " profit or loss" when hedged transaction occurs in comprehensive income. The ineffective part is recorded in " profit and loss" in IS.

For more than 60% (assume 65%) dollar-based revenue, half are naturally hedged, $18. 5billion are instrument hedged and the rest ($1. 5billion) is unhedged. The unhedged part will subject to exchange rate risk when translated at period end rate. Thus exchange gain/ loss will be accounted in " currency translation adjustment for foreign operations" in the comprehensive income. This effect is small for natural hedge since the exchange gain/loss will offset for cost and revenue, asset and liability.

Ratio analysis Ratio analysis will be carried out in the following two directions: time series analyses (compare 2009 with 2010) and cross sectional analyses (compared with its main competitor Boeing). Four aspects will be considered. Return on asset is calculated for the five products. From the business segment information, it can be found that Airbus Commercial always occupies nearly 50% of the total revenue. This product also weighs significantly in Boeing's performance.

In EADS, its consolidated revenue increase from26. 4b in 2009 to 27. 7b in 2010 by 5%. According to registration document (2010: 80), this was due to i) higher quantity of deliveries (from 498 recognized in revenue to 508), a more favorable mixed of product (mainly increase in A380 large aircraft) ii) advance in price (value). However, in terms of EBIT, it decreased from 386m to 291m by 25%. This strange result is caused by the unfavorable hedged rate in 2010, which gave 0. 6 billion loss in this segment. ROA nearly stays the same for this segment.

Airbus Military seems a terrible product with a little share, generating 1, 752m loss in 2009 and returned to ï¿½21m profit in 2010. The huge loss ss caused by 1. 8 billion A400M program contract charge. As a result, its 2009 ROA is relatively low. The depressed product has a totally different situation in Boeing, perform relatively well and generating about $1, 300m income every year stably.

For the other three product, Eurocopter, Astrium, Cassidian, their EBIT changed by -30. 4%, 8. 4%, and 1. 8% separately. Revenues increased by 5. 7%, 4. 3%, 10. 6%. The large decrease in EBIT in Eurocopter was caused by higher research & development cost and thus its ROA is decreased in 2010. The better performance in Astrium is due to growth in defense and military service. For Cassidian, it provides the highest ROA every year and the company has planned a revenue growth for this segment.