

BA Business Management

Student Name: Constantin Gabriel Tacea

Student Number: 2122369

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**Lecturer Name:
Dr. Andry Rakotovoloana**

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INTRODUCTION

The financial management of multinational companies depends on the effective management of foreign exchange risk. Certain strategies are used to manage this risk based on financial management theory.

When there are financial losses due to commercial and/or financial activities in foreign currency transactions and there are transactional currency fluctuations, multinational corporations face foreign exchange risk.

This essay will critically evaluate the strategies that multinational corporations use to manage exposure to foreign exchange risks. Multinational corporations are exposed to foreign exchange risk because they operate in different countries and deal with various currencies. I will provide concrete examples of the risks multinational corporations face due to international financial operations. I will analyze the strategies used by multinational corporations to manage risk, including hedging through forward contracts, currency options, and currency swaps.

FACTORS THAT INFLUENCE EXCHANGE RATE

In his article, Gregory P. Hopper (1997) emphasizes the question even through the title “What Determines the Exchange Rate: Economic Factors or Market Sentiment?”.

The value of a currency in relation to the value of another influential currency affects the exchange rate, and these factors are varied and complex, stemming from economic, political, or market-related factors.

Monetary policy changes, a country's economic performance, financial stability, as well as political stability, all contribute to the value of the currency in relation to another currency. Speculation, market perception, and psychological factors, also known as "market sentiment," play a significant role in currency movements. . “Under this view, the level of the exchange rate

is the result of a self-fulfilling prophecy: participants in the foreign exchange market expect a currency to be at a certain level in the future; when they act on their expectations and buy or sell the currency, it ends up at the predicted level, confirming their expectations.” (Gregory P. Hopper, 1997)

MNCs & Foreign exchange risks

TRANSACTION RISK

The original US-based company Apple operates in the European market. Due to conducting business in multiple currencies, it is exposed to currency exchange risk, as any depreciation of the euro against the US dollar can affect the company's revenues. To avoid currency imbalances, Apple chooses to enter into forward contracts - thus locking in exchange rates and reducing uncertainty.

TRANSLATION RISK

If fluctuations in exchange rates affect a company's balance sheet, then, like Coca-Cola, it diversifies its operations in multiple currencies and countries to diminish the impact of translation.

By diversifying operations, Coca-Cola reduces currency fluctuations and stabilizes financial results reported in the reporting currency. Through this currency, Coca-Cola has not completely eliminated currency risk, but it can reduce the risk of concentration on a single currency and achieve stability in revenues and profits.

ECONOMIC RISK

The economic fluctuations impacting the financial results of a multinational corporation pose a high economic risk because they are exposed to multiple markets and foreign currencies. Due to various factors such as exchange rate fluctuations and their impact on revenues and costs, economic risk arises within the multinational. Managers must make decisions regarding acquisitions (where to buy from) and/or production locations to effectively manage economic exposure.

Currency risk exposures affect cash flows, the company's economic activity, and profitability, which is why hedging strategies with financial instruments are employed to mitigate them.

Financial hedging

Multinational companies use various types of financial instruments to protect the company from currency fluctuations. With their help, companies thus reduce currency risk. I will present the following financial hedging instruments: Forward contracts, currency options, currency swaps, Portfolio diversification.

Forward contracts are purchase or sale contracts whereby a currency transaction is carried out at a future date at an exchange rate established at the time of contract signing. Often, sellers and buyers may be exposed to opposing risks (Pike, Richard, 2015). For example, Mars, a confectionery manufacturer, may be concerned about the rising price of sugar, while Tate & Lyle, a food sweetener producer, may be concerned about the falling price. For such situations, where future prices are difficult to predict, a fixed price can be established.

Through interest rate or currency swaps, risks are managed, and agreements are made between two parties to exchange cash flows or assets over a specified period.

Options are another instrument through which a multinational corporation can have the right, but not the obligation, to buy/sell an underlying asset at a clear price within a predetermined period of time. “The right but not the obligation to buy or sell something at some time in the future at a given price.” (Pike, Richard, 2015, p.343)

Through portfolio diversification, one can invest in multiple different assets, thereby reducing the risk of total loss if one asset underperforms.

Airbus SE – Operational Hedging

A multinational corporation that uses hedging operations to avoid exposure to currency risks is Airbus SE, a major aircraft manufacturer with extensive global operations and reported revenues as follows: 75% in USD, the rest incurred in EUR and GBP.

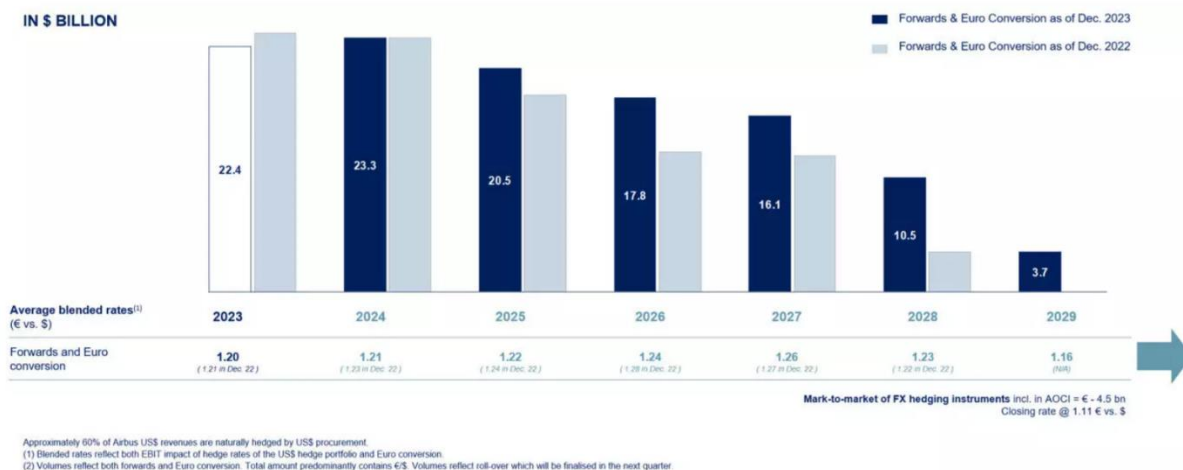


Figure 1: Evolution (Source: airbus, 2024)

Multinational corporations use various strategies to manage and minimize risks “the impact on its EBIT from the volatility of the US dollar” (Airbus, 2023).

Airbus is exposed to foreign exchange risk and employs hedging strategies solely to manage and minimize the impact on EBIT of US dollar volatility.

Through forward contracts, Airbus protects itself from the negative impact of future fluctuations on profitability and cash flows.

As stated in the Financial Statements (2022), Airbus uses currency swaps to allow the company to manage exposure to foreign exchange risk associated with its international operations.

(In € million)	Remaining period						Total
	1 year	2 years	3 years	4 years	5 years	> 5 years	
31 December 2022							
Net forward and swap contracts	20,076	18,636	12,128	8,100	7,284	1,201	67,425
31 December 2021							
Net forward sales contracts	21,225	17,923	17,102	10,899	8,161	7,233	82,543

Figure 2: Foreard and swap contracts (Source: Airbus/Financial Statements, 2022)

Considering that Airbus states in the communication on its official website - Investors | Hedging & Debt Information that it does not intend to generate profits through speculation on exchange rate movements, there is no information indicating that the company uses options as a hedging tool.

However, if Airbus were to use options, a predictable scenario would involve anticipating the price of aircraft fuel. This could potentially increase in the future given the geopolitical situation and could significantly affect Airbus' revenues. In this scenario, if Airbus purchases call options on future oil contracts, then it would have the right to buy oil at a predetermined price. If the price increases in the following months, Airbus can exercise the options and buy oil at the lower exercise price.

RECOMMENDATIONS:

I recommend multinational companies to use various strategies for managing and minimizing currency risk associated with operations.

Among hedging instruments, other currency risk management strategies can also be utilized.

Multinationals can choose to invoice in the local currency, thus avoiding currency risk associated with currency fluctuations. Additionally, it eliminates currency conversion costs and increases financial transparency, allowing for accurate reporting of the company's financial performance in the respective country. Moreover, this method helps in customer retention and improves relationships with local clients, as they can pay in the local currency without being affected by currency fluctuations.

Through geographic diversification, multinationals can reduce the impact of unforeseen regional events (such as catastrophes, political conflicts, economic changes) and gain access to new emerging markets with economic growth potential.

Multinationals can also opt for using derivative financial instruments to manage currency risk and protect against fluctuations in commodity prices.

To manage their capital and resources, multinationals can use financing and investment structuring. MNCs can utilize: Cost of funding optimization, Interest rate risk management, Tax efficiency optimization, Maximizing flexibility and adaptability.

CONCLUSION

Through their activities, multinational corporations are exposed to foreign exchange risks, including transaction risk, translation risk, and economic risk. One way to manage and minimize currency risks is through hedging operations.

It's important to note that hedging helps prevent negative impacts from fluctuations but cannot completely eliminate currency risk. Risks must be concretely and critically evaluated, the financial market and available instruments studied, and the costs involved assessed.

Multinational companies can also use other strategies to minimize currency risk by:

- Invoicing in the local currency to reduce currency risk, save on currency conversion costs, improve financial transparency, and strengthen relationships with local customers.
- Geographic diversification through access to new growth opportunities and optimization of resources and tax structures.
- Derivative financial instruments, which maintain business stability in the international market.
- Efficient and strategic management of capital and resources with a long-term vision.

In conclusion, multinational companies are subject to currency risks, but with effective management and governance adopted through various strategies specific to their activities and markets, these risks can be mitigated.

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