# Powerven: When It Is Imperative to Change

# TheCasesolutions.com

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# Foreign exchange Risk



- What does Rio Tinto regarding foriegn exchange risk?

## Rio Tinto



- British-Australian multinational metals and mining corporation with headquarters in London, United Kingdom.
- The company has operations on six continents but is mainly concentrated in Australia and Canada

# Risk management at Rio Tinto



- Groups earnings, shareholders equity and cash flows influenced by a wide variety of currencies due to geographical dispersion.
- US dollar is main currency
- Generally invest and borrow on floating interest rates. As main currencies rise and fall with commodity prices, offering a natural hedge.

**At 31 December 2013**
**Gains/(losses) associated with 10% strengthening of the US dollar**

| Currency Exposure | Closing exchange rate US cents | Effect on net earnings US$m | Of which amount impacting underlying earnings US$m | Impact directly on equity US$m |
|---|---|---|---|---|
| Australian dollar | 89 | (1,442) | 21 | 20 |
| Canadian dollar | 94 | (3,077) | 30 | – |
| South African rand | 12 | (4) | 1 | 2 |
| Euro | 138 | 372 | (22) | 6 |
| New Zealand dollar | 82 | 51 | – | – |

At 31 December 2012 restated
Gains/(losses) associated with 10% strengthening of the US dollar

# Foreign Risk Management Plan

Three Main types of risk

- Transaction exposure
- Economic/operating exposure
- Translation exposure



## Transaction exposure

- The risk that currency exchange rates will change between the start of a deal and the end.
- Reducing transaction exposure
  - Forward contracts
  - Futures contracts
  - Money market hedge
  - Options
- Locking in vs. not locking in

## Economic/ Operating Exposure

- The result of unexpected currency fluctuations effecting a companies market value and future cash flows.
- If a currency depreciates it can purchase less decreasing supply and therefore commodoty prices.
- Difficult to reduce risk as by nature it is an unexpected change.
  - Exchange rate swaps
  - Market Selection
  - Pricing policies

## Translation exposure

- Financial statement produced by foreign subsidiaries.
- For Rio Tinto
  - Many overseas assets
  - When currency depreciates against home currency, asset prices and cashflow drops.
- Theoretically:
  - Hold all assets in home currency
- Balance sheet hedging of net assets.

# Positives and negatives of Rio Tinto's risk management process



Positives:

• As Rio Tinto does not actively currency hedge it keeps administrative costs low, and enables them to benefit from upwards swings in the market.

• As they have a fluid approach to risk management it allows them to be more interactive and take things on a case-by-case approach. This is beneficial as it gives their Risk management team lots of experience in different incidents.

• Currency risk management does not increase cash flow, in reality consumes cash flow. Thus by not regularly engaging in the practice Rio Tinto can save that cost.

• It is not theoretically possible to outguess the market. And when the market returns to equilibrium the expected net present value of hedging is zero.

Negatives:

• By not hedging and making cash flows known, it makes it more difficult to predict future cash flows. This may affect future investment opportunities

• By not reducing the risk associated with cash flows, management increases the chance that cash inflows will not be sufficient to keep the company out of financial distress.

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## Risk management techniques



- Does not believe in active currency hedging
- Reviews exposure on a regular basis
- Utilizes currency protection where it deems appropriate
  - Aquisitions
  - Disposal
  - Tax
  - Dividends
- Example of money market hedge

Money market hedge example