ALLIANCE DESIGN CONCEPTS FOREIGN EXCHANGE RISK Harvard Case Solution & Analysis

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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

Foreign exchange risk

- Uncertainty of an outcome.
- Reducing that uncertainty
- Identifying, assessing and responding.

Risk that a businesses financial performance or position will be affected by fluctuations in exchange rates between currencies.

Foreign exchange risk sources;

• Where the business imports or exports.
• Where other costs, such as capital expenditure, are denominated in foreign currency.
• Where revenue from exports is received in foreign currency.
• Where other income, such as royalties, interest, dividends etc, is received in foreign currency.
• Where the business's loans are denominated (and therefore payable) in foreign currency.
• Where the business has offshore assets such as operations or subsidiaries that are valued in a foreign currency, or foreign currency deposits.

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.