PGDM Trimester IV

End Term Examination September 2015

International Finance

DM 413

Time 2.30 hours MM 50

This is a closed book examination. Use of ordinary calculator is permitted. In case of any doubts please make reasonable assumptions and proceed. Please write your name and roll no on the question paper as soon as you receive the same

Section A 15 Marks

There are five questions in this section . Attempt any three questions Each question carries five marks.

A1) From the perspective of business managers and investors list three signals that country's BOP data can provide?

A2) Calculate the forward premium on the dollar (being home currency) if the spot rate is 1 Euro is 1.0200 $ and the three month forward rate is 1.0300$?

A3) An exporter has supplied readymade garments to a retailer in Switzerland on six months credit invoiced in 1 Million Swiss Franc . The spot rate and the 6 month forward rates in the Indian Market Swiss Franc is quoted at Rs 65 and Rs 67.50 respectively. If the exporter believes that Indian Rupee would depreciate by 5% p.a., should he hedge the receivables by booking 6 months forward contract?

A4) What is the mechanism of money market hedge for accounts payable?

A5) Why do you think that taxes are important consideration for MNC's to plan their growth?

Section B 20 Marks

There are three questions in this section . Attempt any two questions. Each question carries ten marks

B1) Halon France, the French subsidiary of a U.S. company, Halon, Inc., has the following balance sheet:

Assets	(Euro thousands)	Liabilities	(Euro Thousands)
Cash & Marketable Securities	7000	Accounts Payable	14000
Accounts Receivables	18000	Short Term Debt	8000
Inventory	31000	Long Term Debt	45000
Net Fixed Assets	63000	Equity	52000
	119000		**119000**

a. At the current spot rate of 1 USD = 0.9 Euro , calculate Halon France's accounting exposure under the current/noncurrent, monetary/nonmonetary, temporal, and current rate methods.

b. If Euro depreciate by 5% against USdollar Produce balance sheets for Halon France at the new exchange rate under each of the four alternative translation methods.

B2) Bakrie, an Indonesian conglomerate, is assessing the likely consequences of the rupiah's precipitous decline on its different businesses. These businesses include a telecommunications company that is building a network (using mostly imported equipment) throughout Jakarta to offer wireless service to its residents, a company that sells pipe to the Western firms exploiting Indonesia's oil and gas fields, and a big agricultural business (54% of its revenues are in dollars, compared with 40% of its costs) that owns rubber and palm plantations feeding a large refining and distribution operation.

a. Assess the likely impact of the rupiah's depreciation on Bakrie's three different businesses.
b. Which of Bakrie's businesses will be most hurt by the rupiah's fall? Will any of these businesses actually benefit from rupiah depreciation?

B3) Magnetronics, Inc., a U.S. company, owes its Taiwanese supplier NT$205 million in three months. The company wishes to hedge its NT$ payable. The current spot rate is NT$1 = U.S.$0.03987, and the three-month forward rate is NT$1 = U.S.$0.04051. Magnetronics can also borrow/lend U.S. dollars at an annualized interest rate of 12 percent and Taiwanese dollars at an annualized interest rate of 8 percent.

(a) What is the U.S. dollar accounting entry for this payable?

b. What is the minimum U.S. dollar cost that Magnetronics can lock in for this payable? Describe the procedure it would use to get this price.

c. At what forward rate would interest rate parity hold given the interest rates?

Section C 15 marks (Compulsory)

It was December 2003, and Paul Young, the financial controller of Xian-Janssen Pharmaceutical Ltd (XJP), was preparing for a meeting with the CEO of the company, Christian Velmer, to discuss the 2004 business plan. XJP was Johnson & Johnson's (J&J) joint venture entry into the Chinese market. XJP was one of J&J's largest single operating companies, and was now expected to close 2003 with Rmb 1.006 billion in earnings ($121.6 million). The CEO of XJP had already passed on corporate's earnings objectives for 2004: Rmb 1.205 billion, just under a 20% increase. Although XJP had performed well in recent years, averaging 20% annual earnings growth despite many challenges including the SARS epidemic in 2003, meeting corporate's objectives this time would be difficult. Many of XJP's direct and indirect expenses had been rising, including foreign exchange losses.

Christian Velmer had been CEO of XJP only six months, and Paul Young knew that Velmer would likely accept the corporate directive on earnings. He had little choice. XJP's earnings were core to J&J, and with a number of its traditional markets slowing, the need for growth would be increasingly borne by units like XJP. The management team also knew that if the unit failed to meet its earnings objectives, in addition to management performance reviews and job security, the unit's new product development position could be threatened. Without new products, XJP could lose its number one position in the Chinese market.

XJP of China

XJP produced and marketed prescription and over-the-counter (OTC) medications. The company was the number one foreign pharmaceutical company operating in China, and had been there since 1985. The company's operations were roughly equally divided between Ethical and OTC businesses. 2003 had proven to be a very busy year, with the company successfully weathering two different price cuts, three new Ethical product introductions, not to mention closing the year with a 98% success rate on over 1,200 *tender sales*.[1]

The drug market in China was largely hospital-based, with over 80% of all drug sales reaching consumers through government-run hospitals. The 20% balance of the market was then split between drugstores, small collective or work-unit clinics, and a few but growing private hospitals. The Chinese pharmaceutical market had averaged 12.5% annual growth for the past decade, and was expected to continue at close to that growth rate in the near future. Increases in income and purchasing power by large segments of the urban population, combined with a multitude of medical insurance and health care reforms, had opened the door for many Chinese to Western drugs. The problem was that these same reforms were now channeling insurance reimbursements toward generic drugs, putting more and more pressure on prices. The hospitals themselves were now regularly purchasing through the tender market, in which XJP often found itself making smaller and smaller margins.

Cost and Currency Pressures

XJP's product line covered a wide range of pharmaceutical products, most of which had been either discovered or developed by its parent company. In recent years the company had also licensed a number of third-party drugs through J&J Europe. Historically, 100% of XJP's raw material and finished product was imported from J&J Europe. In 2003, the company had initiated some local sourcing in China, but this still did not constitute more than 5% of purchased inventory. Both pricing and invoicing of XJP's core business still originated in Europe, which meant pricing and invoicing in euros. Paul had also determined in recent months that the transfer prices imposed upon XJP were relatively high compared to other intrafirm purchasers globally.

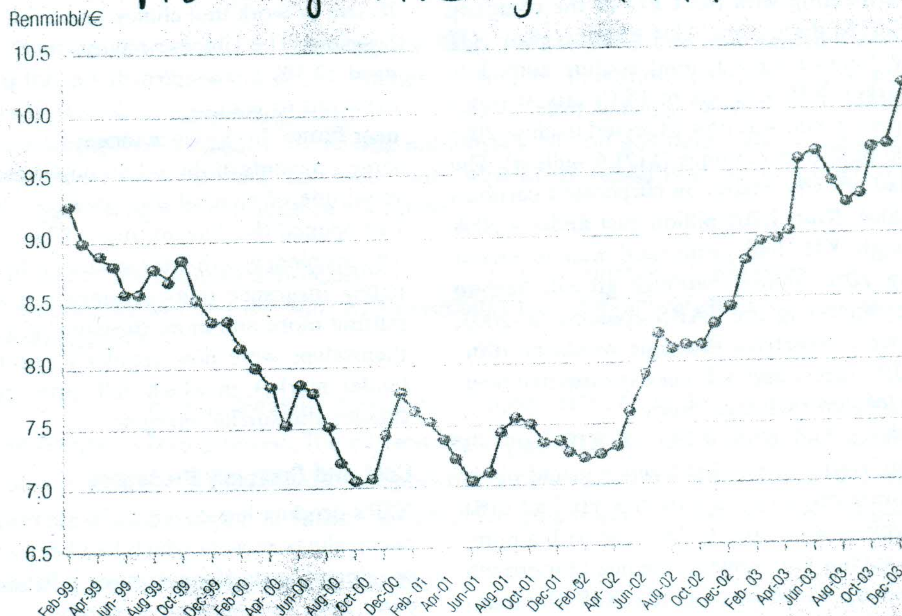
XJP purchased its materials and products from J&J Europe's Belgian treasury center. All payments would be in euros, with XJP incurring the currency risks and expenses internally. Corporate policy required that XJP hedge a minimum of 80% of its anticipated currency exposures, with hedges not to exceed 100%. Currency hedging alternatives were few. After netting whatever payments it could by law per quarter, XJP then purchased forward contracts (buy euro, sell Rmb) from its foreign currency bank in Shanghai. Chinese law restricted the pur-

[1] *Tender sales* were periodic auction purchases by many Chinese hospitals of generic product lines. The sales were conducted like Dutch auctions, in which the buyer rank-ordered bids by lowest price first, accumulating volume until reaching the purchase need. The ~~price of~~ the ~~last incremental~~ offer ~~set the price for that entire auction.~~

Price of last incremental offer set the price of entire ~~[illegible]~~ ~~[illegible]~~ auction.

EXHIBIT 1 Chinese Renminbi/Euro Spot Exchange Rate (monthly average, 1999–2003)

Monthly Average 1999 - 2003



chase of forward contracts to commercial transactions only (forwards could not be purchased for investment purposes).

The Chinese renminbi (Rmb) was fixed to the U.S. dollar at Rmb8.27/$. The dramatic rise of the euro against the dollar throughout 2003 had therefore translated directly into an equally weak Rmb against the euro. Paul Young's bank advisers had recently forecast the euro to remain strong, if not gaining further strength, in 2004. The consensus forecast for the first half of 2004 was $1.30/€, or a cross rate of Rmb10.75/€, what Paul Young considered "off the chart" when he looked at Exhibit 1.

XJP's financial results for 2003 had been greatly affected by the cost of hedging. XJP had budgeted for 2003 (in December 2002) at an average expected spot exchange rate of Rmb8.60/€. But the run-up in the euro had resulted in an average 90-day forward rate for all of 2003 of Rmb9.22/€, culminating in total foreign exchange losses (differences between budgeted spot and forward rate) of Rmb75 million (see Exhibit 2). Of the total Rmb75 million, Rmb60 million would be charged against XJP's 2003 results, and Rmb 15 million would be absorbed in inventory that would be pushed into 2004. Fortunately, as illustrated in Paul Young's financial worksheets in Exhibit 2, the Chinese unit had earned Rmb70 million in one-time (extraordinary) gains on a housing fund adjustment and an inventory valuation reversal. These gains had obviously mitigated the negative impact of the currency losses, but 2004 would most likely not be such a lucky year.

With the dollar closing on $1.30/€ in December (Rmb10.75/€), the 90-day forward rate was also moving up. Paul Young knew that he would have to use a budget rate for 2004 (forecast for the average spot exchange rate for the year) of somewhere between Rmb9.8/€ and Rmb10.0/€. But given the rough forward premium he had been forced to pay in 2003, his after-hedging effective rate could rise to Rmb10.50/€ in 2004. Paul stared at the numbers—specifically his estimate of earnings for 2004—and wondered how in the world he was going to reach corporate's earnings objectives of Rmb 1.205 billion.

Case Questions

1. How significant an impact do foreign exchange gains and losses have on corporate performance at XJP? What is your opinion of how they structure and manage their currency exposures? 4 Marks
2. Johnson & Johnson has roughly 200 foreign subsidiaries worldwide. It has always pursued a highly decentralized organizational structure, in which the individual units are responsible for much of their own performance from the top to the bottom line of the income statement. How is this reflected in the situation XJP finds itself? 4 Marks

EXHIBIT 2 Xian-Janssen Pharmaceutical (China)

Assumed growth in sales and costs:		20%
Chinese renminbi (Rmb)	**2003 Actual**	**2004 Budget**
Total sales	3,353,600,000	4,024,320,000
Gross cost of products sold	(1,040,600,000)	(1,422,960,000)
Gross margin	2,313,000,000	2,601,360,000
Selling, marketing & admin expenses	(1,263,000,000)	(1,515,600,000)
Net operating earnings	1,050,000,000	1,085,760,000
Extraordinary gains (losses)	70,000,000	—
Foreign currency gains (losses)	(60,000,000)	(75,020,000)
Net earnings	1,060,000,000	1,010,740,000
Import purchases worksheet:		
Expected import purchases (euros)	€121,000,000	€145,200,000
Budget spot exchange rate (euro/Rmb)	8.60	9.80
Expected import purchases (Rmb)	1,040,600,000	1,422,960,000
Actual average forward rate (euro/Rmb)	9.22	10.50
Actual cost of imports hedged (Rmb)	1,115,620,000	1,524,600,000
Cost of hedging (Rmb)	(75,020,000)	(101,640,000)
Cost of hedging, to current year (Rmb)	(60,000,000)	(80,000,000)
Cost of hedging, inventory (Rmb)	(15,020,000)	(21,640,000)

Note: Financial values have been fictionalized to preserve confidentiality. 2004 Budget assumes same growth rate in revenues and sales. 2004 foreign currency gains (losses) assume 80% of current year gains (losses) incurred in addition to the inventory costs from the previous year.

3. What is the relationship between actual spot exchange rate, the budgeted spot exchange rate, the forward rate, and the expectations for the Chinese subsidiary's financial results by the U.S. parent company?

4 Marks

4. If you were Paul Young, what would you do?

3 Marks