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**Virtual Treasury**

**IF Importing**

Importing goods & materials:

global profit management

***Virtual Treasury GPS***

Interactive Finance

**Giffnock Consulting Pty Ltd**

**Dr Richard Allan**

0412 699 992 v 0110

***richard.allan@findiag.com.au***

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***Virtual Treasury***

Global Financial GPS

**IF Importing Ltd**

**Global price management case study**

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**Global price management**

**IF Importing Case Study**

***Virtual Treasury*: business objectives**

***Virtual Treasury*** provides a strategic management vehicle to assist companies to manage all their price and commodity exposures – in the current case, foreign exchange.

It also ensures companies are aware of business alternatives to financial market-based solutions.

The outcome is either enhanced value or confirmation that the proposed solution is optimal. Virtual Treasury cannot reduce value. It can, however, potentially lead to lower risk and greater awareness of market opportunities.

***Virtual Treasury* does not** in itself speculate, forecast or sell products. It does allow companies to manage expectations of price movements and verify pricing of financial and contractual alternatives

***Virtual Treasury* does** provide proactive management solutions based solely on IF’s business exposures and goals.

**IF Importing case study**

**Three stage methodology**

1. Establishing opening position and IF’s goals.

2. Four alternative Strategies for IF Importing

3. Non-financial market Strategies

***The final page summarises the case study from the viewpoint of the IF Importing***

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**IF Importing Case Study**

**The issues**

**Miner**

IF Importing is importing USD 10 million of Importing equipment.

This equipment is due in three months, payable on delivery.

The equipment will have zero value within 6 months and will then require replacement.

**Initial issues discussed with IF Importing’s management**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Issue** | **Answer** | **Notes** |
| 1 | What is IF’s Value target? | Net Profit | IF’s specified benchmark(vertical axis) |
| 2 | What is the key Price variable? | AUD/USD | Key variable |
| 3 | What is Net Profit at current prices? | AUD 3 million | Spot value (0.90) |
| 4 | What is amount of the exposure? | USD 10 million | Exposure amount |
| 5 | What is time horizon? | 3 months | Exposure period |
| 6 | Is there an upside target level? | Budgeted Net Profit$3.3M | Potential Ceiling (profit limit) |
| 7 | Is there a downside risk target?  | Retrenchments if profit under $2.6M | Floor (loss limit) |
| 8 | Any repricing clauses or similar contract items? | Don’t know | Check contracts |

**Note: Issues that will be addressed at a later stage include:**

1. Does IF want leverage – or, alternatively, a dampening of exposures?
2. Do you want to take your views on direction of prices into consideration? Scenario analysis?
3. Are there any price levels where there will be a window of opportunity?
4. Any levels that represent a specific danger?

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**IF Importing Case Study**

**Objective of Interactive Finance**

**An initial position is identified:**

**Vertical axis**: Net Profit (A$3.0 million)

**Horizontal axis:** Exchange rate (Spot AUD/USD 0.9000)

**Initial positi**on: Net Profit of A$ 3 million at current *forward* available exchange rate



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**$ Value**

**Net Profit**

**USD 10 M Exposure**

0.84 0.86 0.88 0.90 0.92 0.94 0.96

**AUD/USD**

**USD 10 M Exposure**

**Management Overview**

1. **Net Profit benefits if the Australian Dollar strengthens**.

For every one cent rise in the Australian Dollar (e.g. from 0.9000 to 0.9100) Net profit increases by A$ 122,000 or 4%.

2. **Retrenchments may occur if Net Profits fall below A$ 2.6** M – or AUD/USD 0.8688

3. **Board’s Budgeted Net Profit is A$3.3 M** (exchange rate of AUD/USD 0.9250)

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**Strategy Number 1: Do nothing – remain exposed**

In three months IF pay the then current AUD/USD spot exchange rate.

* **Unlimited upward profit**
* **Unlimited downside risk**

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**Net Profit**

**USD 10 M Exposure**

**AUD/USD**

**Current exchange rate**

**Full cover**

**Retrenchment level (not protected)**

**USD 10 M Exposure**

**Potential outcomes if USD 10 M exposure left uncovered**

|  |  |
| --- | --- |
| Exchange rate | **LEAVE UNCOVERED**Exposed to unlimited upside and downside |
|  | All cash flowsin June |
| 0.80 | A$1.67M |
| 0.82 | A$1.98M |
| 0.84 | A$2.27M |
| 0.86 | A$2.55M |
| 0.88 | A$2.81M |
| **Current 0.90** | **A$3.07M** |
| 0.92 | A$3.31M |
| 0.94 | A$3.54M |
| 0.96 | A$3.76M |

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**Strategy Number 2: Full insurance (Full cover)**

**The exposure is removed by a forward purchase of the US Dollars.**

The rate is determined by costs in US and Australian money markets – no forecasting or speculation occurs.

In three months IF pay an additional A$72K and lock in a Net Profit of $2.927 M Ceiling:



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**Net Profit**

**USD 10 M Exposure**

**AUD/USD**

**100% Cover $2.93 M Profit**

**USD 10 M Exposure**

**Management report\***

1. Shows that Worst rate (floor) and best rate is a Net Profit of A$ 2.927M\*

2. No retrenchments

3. Budget Net Profit shortfall A$ 372K

--------------------------------------------------------------------------------------------------------------

\* Based on 3 month rates of 2.73% p.a. in Australia and 0.23% in the USA.

\* Spot rate: AUD/USD 0.9000 3 month outright forward rate AUD/USD 0.8947

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**Strategy Number 3: Protect floor price – no retrenchments**

**Ceiling & floor levels are added (regardless of cash paid/received)**Ceiling: None

Floor: Retrenchments triggered A$2.6M



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**USD 10 M Exposure**

**AUD/USD**

 **FLOOR**

**Technical report\*** Shows that Floor achieved at a cost of A$137K

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Technical Report: Floor: Objective: No retrenchments (2.6M)

Mechanics: Floor: Total cost A$137K Floor at $2.6M

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**Protect floor price – no retrenchments (Continued)**

**Management report\*** Shows that Floor achieved at Net Profit of A$2.594M



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Managerial Report - Floor @ $2.6M: Objective: No retrenchments (2.6M)

FX No cover With Floor

**OUTCOMES of three Strategies:**

 **0% cover; 100% cover; Floor at $2.6M**

 Amount USD 10 Million Date due: June 201x

|  |  |  |  |
| --- | --- | --- | --- |
| Exchange rate | LEAVE UNCOVEREDExposed to unlimited upside and downside | FULL COVER | FLOOR ONLY |
|  | All cash flows in June | All cash flows in June | Initial costA$137K |
| 0.80 | A$1.67M | A$2.93M | A$2.59M |
| 0.82 | A$1.98M | A$2.93M | A$2.59M |
| 0.84 | A$2.27M | A$2.93M | A$2.59M |
| 0.86 | A$2.55M | A$2.93M | A$2.59M |
| 0.88 | A$2.81M | A$2.93M | A$2.67M |
| **Current 0.90** | A$3.07M | A$2.93M | A$2.93M |
| 0.92 | A$3.31M | A$2.93M | A$3.18M |
| 0.94 | A$3.54M | A$2.93M | A$3.41M |
| 0.96 | A$3.76M | A$2.93M | A$3.64M |

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**Strategy Number 4: Collar – cashless Floor and Ceiling Profits**

**Ceiling & floor levels are added (regardless of cash paid/received)**

Ceiling: Budgeted Net Profit: A$3.3 M

Floor: Retrenchments triggered A$2.6M



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**Methodology – showing underlying building of final position**

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**Collar – cashless Floor and Ceiling Profits - continued**

**Ceiling & floor levels - Final position PRICED**

Shows that Worst rate (floor) is a Net Profit of A$ 2.59M

 Best rate (ceiling) is a Net profit of A$ 3.61M



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Budgeted Net Profit $2.6M

No Retrenchments $2.6M $2.6M

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Exchange rate | LEAVE UNCOVEREDExposed to unlimited upside and downside | FULL COVER | FLOOR ONLY | COLLAR |
|  | All cash flows in June | All cash flows in June | Initial costA$137K | ZeroCash Cost |
| 0.80 | A$1.67M | A$2.93M | A$2.59M | **A$2.59M** |
| 0.82 | A$1.98M | A$2.93M | A$2.59M | **A$2.59M** |
| 0.84 | A$2.27M | A$2.93M | A$2.59M | **A$2.59M** |
| 0.86 | A$2.55M | A$2.93M | A$2.59M | A$2.59M |
| 0.88 | A$2.81M | A$2.93M | A$2.67M | A$2.67M |
| **0.90** | A$3.07M | A$2.93M | A$2.93M | A$2.93M |
| 0.92 | A$3.31M | A$2.93M | A$3.18M | A$3.18M |
| 0.94 | A$3.54M | A$2.93M | A$3.41M | **A$3.61M** |
| 0.96 | A$3.76M | A$2.93M | A$3.64M | **A$3.61M** |

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**Final Board Strategy Report**

**Equipment cost management Strategy

Key trigger levels**

Net Profit A$ 3.3M

Retrenchments A$ 2.6 M



**Global Prices: Opportunity & risk levels**

**201w– 201x**

**NET PROFIT**

 May 1w July 1w Sept 1w Nov 1w Jan 1w Mar 1x 14

**RETRENCH**



**Global Prices: Opportunity & risk levels**

**5 years**

 201t 201u 201v 201w 201x

**RETRENCH**

**NET PROFIT**

|  |  |
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**Alternative Strategies**

**Contract alternatives**

|  |  |
| --- | --- |
| **1. Price in Australian Dollars**Current US Dollar cost: USD 10 million (= A$ 11,200,000 fully covered))Any Australian dollar price UNDER this price (such as spot rate at AUD/USD 0.90 = AUD 11,111,111) would add to Net Profit.**2. Insert repricing clause, sharing benefits and costs of exchange rate movement equally**sharing of 50:50 movement from current spot would save A$36 Kplus get 50% of all upside.  |  |

**Watching Briefs**

**3. Replacement Machine**

**Due to be replaced in November 201x.**

**Current forward (A$ locked in) rate: US$ 10 M = A$ 11.25M**

This would reduce Net profit margin from $3 M to $2.86 M

Notify if either upside or downside triggers breached.

**3. New Global Financial Crisis**

**Major Balance Sheet opportunities due to commercial pressures offshore and onshore.**

**Example: outright cost not only of machinery but of equity in competitors &/or suppliers.**

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**Further adjustments can be made at will**

**Green line: IF Importing now want to simply protect against retrenchments and benefit from any *strengthening* of the Australian Dollar**

**Blue line: IF Importing “high risk/high return” Strategy – although protecting floor to ensure no retrenchments,**

**benefit from any *weakening*  of the Australian Dollar**

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**Strategy to benefit from stronger A$**

Strategy to benefit from weakening A$

**IF Importing can change their Pay-off profile as required**

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**Cost/Benefit review: IF’s perspective**

**1. Transparency**

**Benchmarks and solutions are all based on IF’s commercial issues and targets, not financial instruments or terminology**

**2. Profit and value enhancement**

**Method involves identifying a range of potential solutions, including commercial, contractual and financial market-based options. Also identification of Windows of Opportunity**

**3. ‘Bankability’ - creditworthiness**

**Financial institutions may increase limits/reduce margins because they are aware IF Importing has a clear Strategy based on a quantified set of alternatives**

**4. Reduced margins & fees**

**Financial institutions are also aware IF can independently price potential solutions – so likelihood of excess margins should be reduced**

**5. Absence of forecasting or scenario management in initial review**

**IFs management of expectations or scenario analysis of exchange rate movements is not introduced until after core analysis**

**Decisions based on expectations would be made by IF Importing.**

**Implications**

**Both IF Importing and their financial service providers benefit from the analysis – regardless of which route is taken and whether further benefits occur during the journey.**

***Dr Richard Allan***

***0412 699 992***

***Richard.allan@findiag.com.au***

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