

Transaction Exposure Management: A Case of Shipra Industries Pvt Ltd.

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Shipra Industries Pvt Ltd. is a textile company in Mumbai. The company has widely spread its business of textile in different states with 10 branches all over India. It has been in existence for more than 35 years. In the year 2014, the company realised the need of latest machinery with modern technology for the modernisation of its production plant. After making cost benefit analysis, Mr. Swaroop, the Managing Director of the company decided to import a machinery with in the price range of \$ 2 – 3 million. He asked Mr. Anoop, the General Manager Finance to make a suitable arrangement to finance the purchase of the imported machinery.

Mr. Anoop communicated with suppliers of textile machinery in Switzerland, China and America through emails. He also had several rounds of meetings with their local representatives. He reviewed thoroughly the machinery manufactured by these companies on the basis of specifications given by the Mr. Swaroop. Finally, the company decided to purchase a machinery produced by McCoy Machinery Corporation, USA for USD 2.4 million with delivery at Mumbai.

Mr. Anoop was asked to work out various options to finance the purchase of the imported machinery. It is generally the practice amongst the machinery companies to arrange for the finance from various international banks if the buyer so desires. Being a company based in USA, McCoy Machinery Corporation, had to be paid in USDollar, Mr. Anoop thought of an idea of borrowing long term loan denominated in USDollar(USD) from ICICI Bank. The Mr. Swaroop asked Mr. Anoop also to analyse the option of borrowing in Japanese Yen (JPY).

Mr. Anoop with all his experience did a thorough analysis of raising a loan in USD vis-à-vis JPY. He recommended to the Mr. Swaroop that borrowing in USD is the best option given the volatility in JPY. However, the thinking of the Mr. Swaroop was totally different and he insisted on going for a loan in JPY. Mr. Anoop arranged for a meeting between the Mr. Swaroop and Foreign exchange Dealer of ICICI Bank. The foreign exchange dealer of ICICI Bank recommended that a loan in USD with a forward contract to cover the exchange rate risk would be a safe option. The foreign exchange dealer also advised to cover the interest rate risk also.

Mr. Swaroop was in favour of option of JPY loan as the rate

of interest on JPY was very low at the time being @ 1.5% p.a., (LIBOR + 150 basis points) as compared to rate of interest on a USD denominated loan which was @ 2.5% p.a. (LIBOR + 220 basis points). He was primarily attracted by the interest rate differential of these two currencies. Further, he also had strong view that in the coming years, JPY may not strengthen so much against the USD from the then level of JPY 120 per USD at the time of availing the loan. He believed that any movement of JPY from the level of 120 per USD on either side may be evened out during the period of the loan. Therefore he decided to hold an open position of JPY. Mr. Swaroop asked Mr. Anoop to go for a JPY loan with floating interest rates. Any amount of persuasion by Mr. Anoop to cover at least a part of the loan exposure for exchange rate risk and interest rate risk was not matter of concern for Mr. Swaroop as his decision on the structuring of the loan with open position was final.

At the time of concluding the purchase of the machinery, the INR/USD was hovering around 62 per dollar; the JPY/USD was at 120 per dollar. Interest rates pegged to LIBOR on USD loan was at 2.5% p.a. and the JPY denominated loan was available at 1.5% p.a. for a 5 year loan. These interest rates were floating and were subject to reset clause every quarter based on the 3 months LIBOR prevailing at the beginning of every quarter following the month of availing the loan. The loan of JPY 216 million being 75% of the cost of the machinery (\$ 2.4 million X 120 = JPY 288 million X 75%) was repayable in 60 monthly instalments with interest to be funded separately every month.

All the necessary bank documents to securitize the machinery to the bank were executed in December 2014 and McCoy Machinery Corporation, USA was paid off in USD on 30th December 2014 by availing the loan from the bank in JPY and swapping it to USD at the rate of 120. The machinery was flown from McCoy Machinery Corporation, USA to Mumbai in the first week of January 2015 and the repayment of the JPY loan was to begin from January 2015.

The monthly average exchange rate movement between INR/USD during the years 2015 to 2019 is given in the Annexure-A, the monthly average cross rate between JPY and USD for the period 2015 to 2019 is given in Annexure-

B, monthly average LIBOR rates in USD for three months maturity during the period 2015 to 2019 is given in Annexure-C and the monthly average LIBOR rates in JPY for three months maturity covering the period 2015 to 2019 is given in Annexure-D.

Questions to discuss

Critically evaluate the decision of Mr. Swaroop to take a loan in Yen whereas the company needs US Dollar to make payment to McCoy Machinery Corporation, USA for the machinery?

Do you agree with Mr. Swaroop not to hedge the exchange rate risk in JPY against any aggressive

movement of the currency against the USD and INR? Justify your answer.

Analyse the option of loan in USD instead of loan in JPY with the help of given exchange rates and the LIBOR rates. Do you justify the action of Mr. Swaroop when Mr. Anoop who is the functional head would have been in a better position to take such decisions?

Is there any other better option to finance the imported machinery rather than going for a loan either in USD or JPY? Justify your answer.

Annexure –A

Monthly Average Exchange Rates of INR /USD for the period 2015 to 2019					
Year ->	2015	2016	2017	2018	2019
Month					
January	62.1764	67.283	68.0766	63.6448	70.6595
February	62.0428	68.2812	66.9645	64.4559	71.1954
March	62.5031	66.9023	65.8646	65.0353	69.5846
April	62.6574	66.4686	64.5344	65.6749	69.4124
May	63.7135	66.913	64.4263	67.5296	69.7688
June	63.807	67.256	64.4544	67.7862	69.4234
July	63.6	67.1823	64.4352	68.6785	68.7375

August	65.0852	66.9438	63.9769	69.5434	71.1661
September	66.2377	66.7569	64.4164	72.1397	71.3203
October	65.0274	66.7048	65.0627	73.6061	71.01
November	66.121	67.6687	64.8443	71.8394	71.4973
December	66.4892	67.8108	64.2151	70.7411	71.1728

Annexure –B

Monthly Average Exchange Rates of JPY /USD for the period 2015 to 2019					
Year ->	2015	2016	2017	2018	2019
Month					
January	118.3572	118.4884	115.0283	110.9616	108.9479
February	118.7657	114.5176	112.9725	107.8915	110.3563
March	120.3409	112.9739	112.9577	105.9778	111.1153
April	119.4515	109.5889	110.1778	107.6201	111.7092
May	120.8863	108.9486	112.2042	109.6863	109.9846
June	123.7039	105.328	110.8755	110.0934	108.0781

July	123.3322	103.8295	112.2846	111.4041	108.2262
August	123.0971	101.323	109.7488	110.9972	106.1227
September	120.1145	101.9869	110.719	112.0537	107.488
October	120.1824	103.7105	112.9207	112.7174	108.1203
November	122.607	108.5931	112.8233	113.29	108.8695
December	121.5452	116.1185	112.9265	112.1479	109.1585

Annexure-C

Monthly average USD LIBOR for 3 months maturity					
Year ->	2015	2016	2017	2018	2019
Month					
January	0.254	0.62	1.026	1.734	2.774
February	0.258	0.623	1.045	1.875	2.677
March	0.268	0.632	1.135	2.173	2.606
April	0.276	0.633	1.159	2.349	2.59
May	0.28	0.645	1.186	2.336	2.532
June	0.283	0.652	1.262	2.33	2.397
July	0.291	0.696	1.308	2.339	2.294
August	0.321	0.81	1.314	2.324	2.165
September	0.331	0.85	1.323	2.349	2.125
October	0.321	0.879	1.361	2.461	1.977
November	0.371	0.908	1.434	2.649	1.905
December	0.533	0.975	1.602	2.788	1.908

Monthly average JPY LIBOR for 3 months maturity					
Year ->	2015	2016	2017	2018	2019
Month					
January	0.103	0.08	-0.023	-0.032	-0.078
February	0.102	0.014	-0.008	-0.062	-0.084
March	0.097	-0.005	0.001	-0.05	0.072
April	0.095	-0.019	0.015	-0.036	-0.063
May	0.100	-0.025	-0.007	-0.028	-0.07
June	0.097	-0.032	-0.006	-0.037	-0.067
July	0.098	-0.032	-0.008	-0.039	-0.075
August	0.093	-0.022	-0.026	-0.035	-0.098
September	0.084	-0.031	-0.033	-0.04	-0.093
October	0.081	-0.016	-0.041	-0.082	-0.112
November	0.075	-0.058	-0.035	-0.105	-0.101
December	0.079	-0.039	-0.022	-0.100	-0.063