

Kemica's Foreign Exchange (FX) Hedge Strategy

A Case Study in FX/Commodity Price Hedging of a Petrochemical Joint Venture

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Abstract

Financial theory has struggled for years to provide clear guidance on foreign exchange hedging. Much uncertainty derives from the fact that foreign exchange rates are very unpredictable. This is especially so with floating rate currencies – the bulk of the world's traded currencies. Financial theory has long argued that investors are unlikely to outguess efficient markets over an extended period. Thus, when transactions costs are factored in, hedging programs are likely to destroy value. Add to this the risk of financial control breaches and a compelling case exists that hedging is seldom justified.

The insurance principle provides the most effective rebuttal to this position – that it makes sense to pay a sum certain to insure against an unacceptable loss. Firms have long found it prudent to insure their physical assets against catastrophic losses due to accidents or Acts of God. Since value destruction accelerates as firms approach bankruptcy, catastrophe insurance has proven an economic way to prevent a sudden physical disaster from destroying an otherwise viable firm.

Application of the insurance principle becomes less straightforward when the subject becomes financial gains/losses. What then defines an unacceptable loss? Is missing the firm's quarterly earnings target unacceptable? How about earning less than projected on an important capital investment? Matters get still more complicated when one factors in potential agency risks – e.g. hedging the firm's earnings guidance may benefit senior management's incentive compensation even if it destroys shareholder value over time. It can be argued that firms too seldom determine whether the potential financial loss being hedged is truly unacceptable.

This case presents a petrochemical joint venture in the throes of a debt restructuring. Kemica's financial results have been hurt by a rising Australian dollar (\$A). This has occurred because Kemica operates in an "import parity" market, i.e. imported product sets the local market price. Unfortunately, Kemica faces competition from low cost "offshore plants," including large scale Middle East units with cheap feedstocks. Now Kemica's bankers are demanding a currency hedging policy/program. One Kemica partner believes in the value of hedging financial results, the other does not. Students will need to evaluate Kemica's true Foreign Exchange exposure, define whether the risks to be hedged involve unacceptable loss, and if so determine a cost effective hedge program.

This case study references debt restructuring negotiations which occurred in 2003-04.