EXCHANGE RATE DYNAMICS: HOW RELEVANT THEY ARE IN LEATHER INDUSTRY?

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THE GREATEST PLEASURE IN LIFE IS DOING WHAT PEOPLE SAY THAT 'YOU CAN NOT DO IT'

LEATHER INDUSTRY AT A GLANCE

- Exports (USD 3.79 billion during FY 2010-11)
- Employment (around 3 million people)
- Growth (10th largest forex earner of India)
- Large production base (~2100 tanneries)
- India's share in the global leather prodn. ~3%
- It is estimated to reach 4% by 2017

INDIAN LEATHER INDUSTRY

STRENGTHS
- Raw material base
- Skilled and cheap labour
- Technology
- Government's policy stance

WEAKNESSES
- International price fluctuations
- Increasing labour costs
- International standards – stringent norms

INDIAN LEATHER INDUSTRY

OPPORTUNITIES
- Rising per capita use of leather in India
- Growing fashion consciousness
- Leverage of IT in the production process
- E-commerce market

THREATS
- Unorganised industry
- Funding constraints
- Huge competition (East European & Asian countries)
- High quality standards

DETERMINANTS OF EXCHANGE RATES

- Interest Rate Differential
- Balance of Payments
- Forward premium
- Relative output level
- Relative money supply
- Relative factor costs
- Real Effective Exchange Rate (REER)
- RBI’s intervention in the forex market
- Market Sentiments / Expectations / Positions

WHY INR DEPRECIATED VIS-À-VIS USD DURING THE LAST ONE YEAR?

- US is in crisis; Europe is in catastrophe.
- Growth outlook in Japan is negative; China is not positive.
- Prices of crude (very rude)
- Higher domestic interest rates
- Policy inertia
- Infrastructure projects – (delay or deny)
- Mounting CAD
- Downgrading of sovereign credit rating

THE ROAD AHEAD

- GDP growth rate pegged at 5.5%
- Fiscal Deficit
- Deficient and uneven monsoon
- Burgeoning inflation
- No reduction in interest rates
- Weak demand on the external front
- Low capex budgets
- Inadequate availability of skilled manpower
- Lack of political consensus
- Infrastructural bottlenecks

DERIVATIVES – A PRIMER

Are they weapons of wealth destruction?

(or)

Tools of Risk Management?

Derivatives – Condemned financial products

OBJECTIVES OF DERIVATIVES

- ✓ To minimise the risks (hedging) but not to maximise the profit
- ✓ Price discovery
- ✓ Providing liquidity to the market
- ✓ Increasing the breadth & depth of the market
- ✓ Gamblers' / speculators' tools

FORWARD CONTRACT (IS IT FORWARD LOOKING?)

- A plain vanilla OTC derivative product
- Price
- Quantity
- Delivery date
- Nil margin (of late, Banks are insisting)
- Settlement on due date by delivery in most of the cases
- Most suitable for exporters, importers, investors and borrowers in FC

FORWARD SALE CONTRACT – AN ILLUSTRATION

- **An exporter booked a forward sale contract for his export receivables of Euro 1 million @ Rs.68 on 1.4.12 for delivery on 30.6.12. spot rate is 69.**

Scenario	Rate on 30.6.12	Receivables	Profit / (Loss)
I	67.00	67,000,000	1,000,000
II	68.00	68,000,000	Nil
III	70.00	70,000,000	(2,000,000)

FORWARD PURCHASE CONTRACT – AN ILLUSTRATION

- **An importer booked a forward purchase contract for his import payment of GBP 1 million @ Rs. 90 on 1.5.12 for delivery on 31.7.12. Spot rate is 87.**

Scenario	Spot Rate on 31.7.12	Payable	Profit / (Loss)
I	88.00	88,000,000	(2,000,000)
II	90.00	90,000,000	Nil
III	91.50	91,500,000	1,500,000

FUTURES n FEATURES

Futures is a standardised forward contract. Its standard features are:

- Quantum (standard lots)
- Delivery date (last Thursday of every month)
- Marking to Market
- Margin (initial margin, maintenance margin)
- Exchange traded derivative (exchange is the counter party, so no default risk)

CURRENCY FUTURES (USD/INR) – AN ILLUSTRATION

Date	Price	Initial margin	Margin call	Mnt. Margin	MTM
01.8.12	55000	**6000**		**2000**	
02.8.12	53000	4000		2000	-2000
03.8.12	54000	5000		2000	1000
06.8.12	56000	7000		2000	2000
07.8.12	55000	6000		2000	-1000
08.8.12	52000	3000		2000	-3000
09.8.12	**50000**	3000	**2000**	2000	-2000
10.8.12	**49000**	3000	**1000**	2000	-1000
13.8.12	49000	3000		2000	0
14.8.12	50500	4500		2000	1500
			Net gain		**-4500**

FORWARDS Vs FUTURES

FORWARDS	FUTURES
1. A tailor-made contract	1. Standardised
2. Delivery date customised	2. Fixed dates of delivery
3. Quantum - flexibility	3. Standard quantum
4. Negotiation of price – OTC	4. Fixed price
5. Credit risk	5. No default risk
6. Not Exchange traded	6. Exchange traded and has liquidity during the contract period

OPTIONS ARE OPTIONAL

- A contract confers a right to buy or sell an asset at a pre-determined price on a future date by paying option premium, but there is *no obligation* to perform the contract.
- Call option – Right to buy
- Put option – Right to sell
- European options
- American options
- Black & Schoels Model - valuation

CALL OPTION – AN ILLUSTRATION

- **On April 1, 2012, 'Bata India Ltd.' purchased a European Call Option on GBP against USD at a strike price of USD 1.50 for a premium of USD 0.05. The spot rate is 1.57. Expiry date is June 30, 2012.**

Scenario	Spot Rate on 30.6.12	Profit/loss	Position
I	1.68	0.13	ITM
II	1.55	0.00	ATM
III	1.44	(0.05)	OTM

PUT OPTION – AN ILLUSTRATION

- **On July 1, 2012, Liberty Shoes Ltd. purchased a Put Option on Euro against USD at a strike price of USD 1.25 for a premium of USD 0.07. The spot rate is 1.20. Expiry date is July 31, 2012.**

Scenario	**Spot Rate on 31.7.12**	**Profit/loss**	**Position**
I	1.06	0.12	ITM
II	1.18	0.00	ATM
III	1.35	(0.07)	OTM

INTEREST RATE SWAP – AN ILLUSTRATION

- **Zenith Exports borrowed an FC loan of Euro 5 million at Euro LIBOR + 450 bps for 5 years**
- **Enters IRS at 5% p.a.on. Pay fixed – Receive floating.**

Scenario	**Euro LIBOR**	**Spread**	**Floating Interest**	**Fixed Interest**
I	0.25	4.5	+4.75	-5.0
II	0.5	4.5	+5.0	-5.0
III	**2.0**	**4.5**	**6.5**	**5.0**
			Receive	**Pay**

SELL-BUY SWAP – AN ILLUSTRATION

Relaxo has an inward remittance of USD 10 Mn. value spot. It also has an import payment due after 3 months for USD 10 Mn.
Spot rate is USD/INR 55.70. Forward rate for 3 months is 56.00. Bank's margin is 0.1%.

Sell Spot – USD 10 Mn. & Buy Forward – 3 Mth Plus Bank's margin 6 paise. So Relaxo has to pay 36 paise on USD 10 Mn.= Rs.36 lacs

CURRENCY SWAP – AN ILLUSTRATION

- **A US MNC wants to raise JPY 80 Mn. for its subsidiary in Tokyo for 3 years. Similarly, a Japanese MNC wants to raise USD 1 Mn. for its subsidiary in New York for 3 years.**

MNC	Home (RoI)	Foreign (RoI)	Swaps
US	**2.00**	3.00	Raises USD 1 Mn. at 2% and swaps (gain of 1%)
Japan	**1.00**	2.50	Raises JPY 80 Mn. at 1% and swaps (gain of 1.5%)

WHAT IS THE KEY TAKEAWAY?

- *Nobody can really guarantee the future. The best we can do is size up the chances, calculate the risks involved, estimate our ability to deal with them, and then make our plans with confidence.*

- Henry Ford II

THANK YOU

Move out of your comfort zone. You can only grow if you are willing to feel awkward and uncomfortable when you try something new.