

Xian-Janssen Pharmaceutical (China) and the Euro

How can the Chinese subsidiary of a multinational company both hedge its currency risks and still meet the sales and profitability objectives directed by leadership?

€

R_x

Rmb

Xian-Janssen: 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?**
 - Foreign exchange gains and losses could have a significant impact on the corporate performance of any firm. XJP faces foreign exchange risks in form of transactional and operational exposures in the course of its procurement of raw materials and finished products from its J J Europe unit .
 - Johnson and Johnson's corporate policy required that Xian-Janssen hedge at least 80% of all anticipated currency risk exposures.
 - The company decided to net all possible payments per quarter and purchase forward contracts to buy euro and sell Rmb. However, the cost of the forward contracts were having a significant negative impact on Xian-Janssen's financial results.

Q1. 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?



- In 2003 alone, Xian-Janssen experienced Rmb 75 million in foreign exchange losses due to increases in the 90-day forward rate. For 2004, Paul Young had to discover a way to simultaneously hedge against currency risk and still meet the company's profitability objectives.
- To minimize this risk , XJP has followed a hedging policy. In spite of XJP hedging a minimum of 80 of its anticipated currency exposures , it was subjected to huge quantum of translational exposure
- The income statement for the business unit shows foreign exchange losses of Rmb 60 million in 2003 and another Rmb 75 million forecast for 2004, about 5.7% and 6.9%, respectively.

q1. 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?



- Although many people may first see these as relatively small losses, a reduction in the operating earnings of an individual business unit from foreign exchange changes alone like this would be considered significant.
- One way to note this is to consider that the average return on sales (ROS) for the Fortune 500 in the second quarter of 2005 was about 7.7%. If these bottom line profits were chopped an additional 6%-7% on a consolidated basis, a lot of companies – and shareholders – would be considerably upset.

Q1. 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?



- The pure use of foreign exchange forwards is most likely the result of a series of factors:
 - 1) limited availability of other foreign exchange derivatives or risk management alternatives;
 - 2) corporate policy on the part of Johnson & Johnson;
 - 3) regulatory restrictions in China on the use of derivative and currency products;
 - 4) the unwillingness of the parent company to either carry the risk itself or allow more breadth in management (including remaining uncovered as the euro seemingly peaks) of the foreign exchange exposures of its Chinese unit.

Xian-Janssen: Case Questions



2. **J& J has roughly 200 foreign subsidiaries worldwide. It has always pursued a highly decentralized organizational structure, in which the individual units are responsible for their own performance from the top to the bottom line of the income statement. How is this reflected in the situation XJP finds itself?**
 - Although it is not unusual for a multinational firm to make foreign exchange gains and losses the responsibility of its foreign subsidiaries, it is not typically considered very efficient.

Q2. Should individual units take responsibility for their own performance? – XJP case



- The subsidiary business unit is typically just that, a business unit, and does not ordinarily possess the resources of skills sets necessary for good exchange rate risk management.
- That said, the strongest argument for placing foreign exchange responsibilities on the subsidiary unit is that it creates those exposures, and who better to charge with their minimization and management?

Xian-Janssen: Case Questions



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?**
 - Nearly all multinational companies, like all organizations, operate off of budgets. The Chinese subsidiary of J&J is no different. Paul Young must put together a strategic business and marketing plan, combined with a budget, for Xian-Janssen's coming year. That is the reality of the situation.

Q3. Exchange rates and Expectations for the Chinese subsidiary's financial results by the U.S. parent company



- The forecast exchange rate for the coming year, the budget rate, is typically either generated exclusively by corporate or in combination with input from the specific business unit.
- Regardless of the process, the final budgeted rate will be used for all planning, purchasing, and worst of all – formation of expectations. As is the case with all forecasts, it will prove wrong.
- Paul Young just hopes it will not be “too wrong,” and that the direction of the error prove in his business unit’s favor.

Xian-Janssen: Case Questions



- Once the budget was set and accepted by the U.S. parent, Paul Young and Xian-Janssen's results for the coming year would be carved in stone. They would then be managing the business to meet the parent company's expectations, in this case, of 20% growth.
- The forward rate is calculated by financial service providers from the current spot rate and interest differentials. Since the Rmb was fixed to the dollar at this time, and the euro was continuing to appreciate versus the dollar, Xian-Janssen's financial results were looking at weaker and weaker euro results.
- The forward rate was costing Xian-Janssen more and more money. Paul Young would feel increasing pressure to forego the hedging in order to reduce the cost.

Xian-Janssen: Case Questions



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

- This is a very interesting situation. If Paul Young actually has the ability to not hedge his European cost of good sold, many students will argue that it is worth “the risk” of going unhedged.
- One might argue, however, that there should be greater risk associated with running a business unit without hedging its primary cost of goods Sold as opposed to the declining margins on properly hedged purchases.
- In the case of going hedged and suffering the higher costs, the primary downside is the wrath of not meeting the parent company’s expected sales or profits for the year.
- The downside of going unhedged, and then suffering some significant adverse exchange rate changes, could very well be much worse.