Case Study 4:

Rolls-Royce

It seems almost incredible to consider the fact that one of the UK's most prestigious companies, with a proud history of globally-renowned excellence and with a product – aircraft engines – which is used by over half of the world's airlines, could suffer significant losses from one of its most obviously risky exposures – exchange rate volatility.

The picture is clouded even further by the fact that, about eighteen months earlier, Rolls-Royce were admitting that they had entered into a poorly-judged fixed-rate hedging strategy on about USD 22.5 billion of US Dollar income with an expiry of as much as six years forward. (bloomberg.com 15-03-2013)

That approach relied on the British Pound ("GBP") remaining weak on a long-term basis but the strength of the Pound between mid-2013 and mid-2014 has prompted yet another distress call, with the rising currency reducing 2014 first-half revenues by GBP 226 million and profits by GBP 21 million, according to the UK's Daily Telegraph.

Rolls-Royce acknowledge that about half of their revenue is exposed to the effects of exchange rate volatility, so it is clear that their previous hedging strategies have proved ineffective – which suggests they probably have the wrong strategies in the first place. Unusually, however, the company has taken the step of announcing the precise effect of exchange rate movements on their performance: a one cent movement in the US Dollar rate affects underlying revenue by GBP 15 million and profit by GBP 2.5 million, annually. They are also exposed to the Euro, to the extent of GBP 40 million and GBP 4 million per one cent of movement respectively.

All of this suggests that they might have been better with a more flexible approach to hedging – fixed-rate strategies are not usually appropriate for coping with the sort of movements the foreign exchange market has experienced in recent months.

To discuss the issues facing Rolls-Royce, or for a no obligation conversation on your own exchange rate exposures, please e-mail us by clicking here.

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