Group 1
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Tiffany & Co.

Research Report

Tiffany & Co. is an American luxury jewelry and specialty retailer company. It was founded in 1837 by Charles Tiffany and John Young and named "Stationery and fancy good Emporium." Later it was renamed "Tiffany & Co." in 1853 when Charles Tiffany took control and established the firm's emphasis on jewelry. Tiffany was well known for its luxury goods such as diamonds and sterling silver, crystal, stationery, fragrances, water bottles, watches, personal accessories, as well as some leather goods, etc. These goods are sold at stores and through direct mail and corporate merchandising.

Mitsukoshi, founded in 1673, is a Japan-based international department store headquartered in Tokyo. It started as a shop selling Kimonos, who sold their products in one place in exchange for cash on the spot instead of following the trend of selling the products door-to-door. Tiffany and Mitsukoshi had maintained a business relationship since 1972 when Mitsukoshi introduced Tiffany & Co. to its Japanese customer base.

We need to identify whether Tiffany needs to manage its risk by hedging. For that, we need to estimate what are is the earning for Tiffany for FY1993. We made a few adjustments in revenue calculation based on justifiable assumptions. They are as follows:

1. Tiffany's sales accounted for 1% of the $20 billion Japanese jewelry Market = $200 million
2. We assume a 20% decrease in Retail prices when Tiffany lowers prices to increase sales after taking over the operations of 29 Mitsukoshi boutiques.
3. After the repurchase agreement with Tiffany, Mitsukoshi would receive a fee equaling 27% of net retail sales in compensation for providing boutique facilities, sales staff, collection of receivables, and security for store inventory.
4. COGS cost equals 50% of $110 million. We assume an 80% retail margin on average, above prices in the US. Adjusting for the extra retail margin, We estimate Tiffany's market share of sales to approximately $110 million.
5. Corporate tax was approximately 52% in Jul 1993

Quantifying expected earnings after taking over the operations of 29 Mitsukoshi Boutiques (estimations shown in the table below)

Table 1: Earnings from Tiffany's operations in Japan, Estimation

Legends	Formula and extra info	in Millions of USD
1% of $20 billion		200.00
Adjustment for 20% reduction in Retail Price	200 * (1-0.2)	160.00
Adjustment for 27% transfer of revenue to Mitsukoshi	160*(1-0.27)	116.80
COGS (assuming COGS = 50% of 110 Million)	110*0.5	55.00
Gross Profit	116.8-55	61.80
Interest Payed @6% on $25 million		0.75
Earnings before Tax		61.05
Corporate tax (52%)	0.52*61.8	32.14
Earnings after tax		28.91

Tiffany should actively manage the yen-dollar exchange-rate risk. Tiffany, for the FY2019, has an estimated expansion expenditure of $18 million. To cover that expenditure, Tiffany can use internally generated cash or borrow from the $100 million credit revolver at Eurodollar rate, Prime rate, Money market rate, Certificate of Deposit rate. Tiffany would prefer to use internally generated cash to fund this expansion because as we can see from Exhibit 3

There are four reasons to support this argument

1)Total sales are down by 1.12% YoY

2) Profit margin is down from 6.5% in FY1991 to 3.2% in FY1992

3) The stock price of Tiffany is down (High: from $57.5 in FY1991 to $52.9 in FY1993 and Low: from $32.6 in FY1991 to $23.0 in FY1992) and

4) total debt to capital is up from 24% in FY1991 to 30% in FY1992, and as of Jul 1993, Total Debt to Capital ratio is 32.4% (calculated using data from Exhibit 2).

The more Debt Tiffany takes, the more expensive it becomes for tiffany to take on debt in the future. Hence, Tiffany would prefer to fund its expansion through internally generated cash. As Tiffany has taken operational control of 29 boutiques previously operated by Mitsukoshi, they will be earning YEN in their income statements. Though Tiffany can invest in Japan, the slowing Japanese economy makes that option less attractive. To transfer funds out of Japan (in dollar amount), Tiffany is exposed to exchange rate risk because of evidence of YEN being overvalued against the Dollar, as we can see from Exhibit 7. Tiffany's management wants the value of their stocks to grow because of market demand and increase sales, rather than because of foreign exchange speculation.

Since Earnings are approximately $29 million, we can infer that if Tiffany wishes to send a maximum of $18 million to expand in other parts of the world (including the US), hence tiffany has $18 million exposed to exchange rate risk.

The picture below is Exhibit 7 from the paper, shows the estimated Overvaluation of Yen against US Dollar

Exhibit 7 Japanese Yen: Percent Over/Under Valued vs. U.S. Dollar[a]

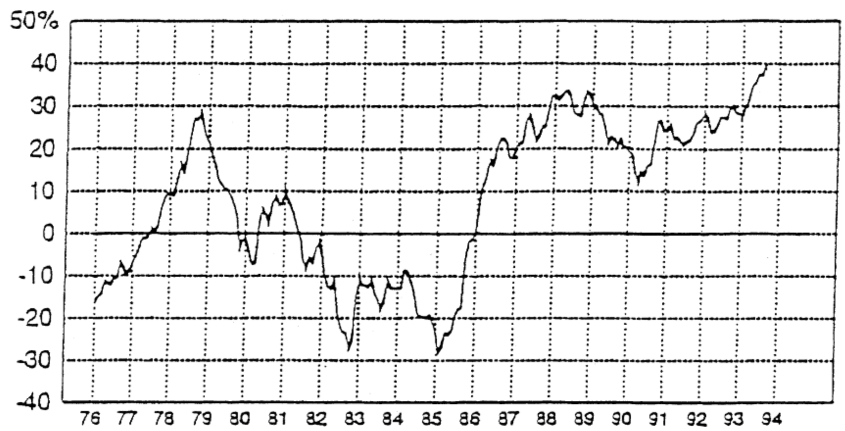

Figure 1: Exhibit 7 from Tiffany & Co. case study

As Tiffany has taken operational control of 29 boutiques previously operated by Mitsukoshi, they will be earning YEN in their income statements. Due to the significant number of tiffany boutiques already operating in Japan, future openings there were expected to occur only at a very modest rate in the near-term future. Hence, to transfer funds out of Japan (in dollar amount), Tiffany was exposed to exchange rate risk because of evidence of YEN being overvalued against the Dollar, as we can see from Exhibit 7. YEN is approximately 30% overvalued against Dollar as of 31st Jan 1993 and can crash just as US Dollar did in 1985. Hence, the exchange rate risk.

There are two choices for Hedging strategy 1) Forward contract and 2) Put Option. If Tiffany uses the forward Contract to hedge risk, Tiffany can trade at a fixed exchange rate without worrying about the risk of exchange rate fluctuations. If Tiffany is not optimistic about the yen, it could use put option to profit from the change. No matter when Tiffany decided to convert its business strategy and bear the exchange rate risk of yen-dollar, it would be necessary to manage the exchange rate risk more actively.

Table 2: Forward Contract estimation

	Yen amount (in millions) required to buy $18 million 1 month later	Yen amount (in millions) required to buy $18 million 3 months later
Forward Contract (assuming spot and forward rates as of Jun 1993)	1,914	1,913

Table 3: Put Option price estimation

	Yen amount (in millions) required to secure a minimum of $18 million 1 month later	Yen amount (in millions) required to secure a minimum of $18 million 2 months later	Yen amount (in millions) required to secure a minimum of $18 million 3 months later
Put Options price	25.7	23.2	42.2

The yen-dollar exchange-rate risk arises from the profit transfer from Japan to the United States. Tiffany's profits are converted to US dollars, but local Japanese products sell in Japanese yen. If you do not manage the exchange rate risk, Tiffany's future finances will also be seriously affected.

The fundamental Objective to manage exchange rate risk would be to minimize potential currency losses, not to make a profit from foreign exchange fluctuations, which are unpredictable. The Objective is to reduce exposure to potential financial losses due to the devaluation of yen against the US Dollar. On the other hand, if we consider hedging the risk, it has its pros and cons. It would be easier for the company to plan ahead of time, helping them to finance projects. It would also help them in approximating how much this funding costs them.