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9B19N024

cs publishing inc.: foreign exchange risk management

Stephan Sapp wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

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It was March 29, 2019, and Martha Singh, director of CS Publishing Inc. (CSPub), a subsidiary of Canada Specialization Providers (CSP), was just finishing her year-end reports for the 2018 fiscal year. CSP was a Canada-based, not-for-profit provider of specialized educational programs. Although all of CSP’s revenues and almost all of the costs from the company’s main business were in Canadian dollars, Singh noticed a significant realized currency loss at CSPub. Because the publishing industry had low margins, this currency loss was a potential concern for Singh. Neither CSPub nor its parent, CSP, had a formal foreign exchange (FX) risk management policy in place; as CSPub was eyeing future international growth, these results made Singh wonder whether it would be wise to consider developing such a policy. Singh needed to pull together some information to better understand CSPub’s current and expected future exposures to currency risk and how these would affect the parent company, CSP.

CS Publishing Inc.: The Subsidiary

CSP provided customized educational programs, consulting services, and associated educational materials to groups and individuals in Canada. CSPub—the subsidiary that dealt with the production and sale of educational materials that were generated both in house and externally—had some international operations, which had led to the FX losses Singh had found. CSPub was currently in the process of expanding its global sales, which were expected to provide opportunities for future growth, especially in Asia.

CSPub originated as the department tasked with preparing and professionalizing the presentation of the materials for CSP’s programs. As CSP grew, so did CSPub, gradually selling its services in preparing, publishing, and marketing education-oriented materials to organizations outside of CSP. CSPub started at the same time as CSP, in the 1960s, and focused first on internal sales, then in the 1970s, on sales across Canada. By the 1990s, CSPub had expanded into the United States, and in the 2000s, into Asia. Its Asian sales were facilitated through an informal partnership with a Hong Kong company with strong ties to Canadian businesses in Vancouver. In 2019, Asia was viewed as the major driver of growth in the educational materials industry, and CSPub had just signed an agreement to establish a more solid international footprint through a formal partnership with a group based in China. As a result of these changes, now was a logical time to consider the need for an FX risk management policy at CSPub and CSP.

Canada Specialization Providers: The parent company

CSP was a medium-sized custom educational services provider based in Montreal, Quebec. Its major products included customized educational programs in niche markets where adequate expertise was not always available, consulting services, and the development and sale of associated educational materials to groups and individuals in Canada. The educational materials included research-based books; foundational books in various disciplines; papers presenting cutting-edge ideas; self-help materials; and multimedia, business-oriented educational materials. Although CSP had revenues of over CA$60 million,[[1]](#footnote-1) as a not-for-profit organization, it had profits of only about $3 million. Because the majority of CSP and CSPub’s revenues and costs were in Canadian dollars, FX risk had not been a consideration until recently. CSPub’s US dollar sales were growing through sales in the United States and Hong Kong (the Hong Kong dollar was pegged to the US dollar), and these sales were allowing FX rates to influence the company’s operations. Recent changes in the Canadian dollar–US dollar exchange rate had resulted in the recent FX losses. Despite the relatively small effect of CSPub’s realized FX losses on CSP’s financial statements, Singh wanted to know more, as CSPub’s future FX exposure was expected to increase substantially.

CSP was currently in a reasonably solid financial situation (see Exhibits 1 and 2). However, the danger of its small profit margins had been exposed three years earlier, when CSP had experienced its first-ever loss. Due to its not-for-profit status, this loss had led to significant austerity measures that had required a large number of layoffs and budget reductions, the effects of which were still being felt in the organization.

Both the effect of the recent losses on the company’s organizational structure and the fact that losses from foreign sales at CSPub could impact CSP forced Singh to look more closely at the situation. The FX exposure was not a one-off situation; rather, the company’s current plans suggested this situation would continue to increase as CSPub continued to expand its operations outside of Canada. Singh knew that she needed to determine both how to manage the current risks faced by the subsidiary and what processes, if any, to put in place to manage the risks that would inevitably arise in the future.

CSPub’s Expansion in Asia

Although CSPub was small in size, with revenues of about $8.5 million, it was a global publisher and distributor of multimedia learning materials across a broad spectrum of disciplines. CSPub committed significant resources to selecting and preparing learning materials, which were provided by individual authors and organizations. Until now, CSPub had managed everything from its Canadian office, located within the CSP headquarters. Because CSPub saw its sales in Asia growing while those in North America were struggling, Asia was viewed as “the place it had to be.” Consequently, CSPub felt it needed to establish a more formal distribution partnership in Asia, so it signed an agreement with a major Chinese publishing house. The agreement and all associated work would be managed through Singapore to avoid tariffs and other restrictions to accessing the Chinese market.

To facilitate the Singapore base, CSPub decided to purchase a facility in Singapore, where it would assemble the products and prepare them for shipment throughout Asia. Although the partnership agreement for Asian sales had all sales in Singapore dollars, the majority of the production costs would still be in Canadian dollars. The majority of CSPub’s fixed costs for the materials related to vetting, editing, and visually preparing the materials before distribution—all of which would continue to be done in Canada for quality assurance purposes. Naturally, the new structure would also require both fixed costs associated with the facility and variable costs related to the final shipping preparations, shipping costs, and marketing; these costs would be in Singapore dollars. Modern printing and video technology made it easy to perform the final preparation in Singapore at a low cost—cheaper than shipping everything from Canada. The authors, or those who originally developed the materials, were paid a 15 per cent royalty on the sales of their works. These payments were all made in Canadian dollars, regardless of the currency received for the sale of the materials.

CSPub had more than 8,000 titles of its own and had negotiated licensing and distribution agreements to sell an additional 23,000 products in Canada and select Asian countries. The North American market for educational materials (including printed and electronic matter) was becoming saturated, so, for growth, CSPub was looking to the Asian market, which was one of the few that were still growing. CSPub had signed an agreement with a Chinese clearing house that had relationships both inside and outside of China and thus could facilitate CSPub’s sales of products in China and elsewhere in Asia.

Shortly after signing this agreement, CSPub had agreed to purchase the distribution base in Singapore. The distribution agreement required an upfront payment of SG$100,000[[2]](#footnote-2) for information technology (IT) upgrades and the necessary software and facilities to access the Chinese partner’s distribution channels. This amount had to be paid to an outside contractor at the end of September 2019. The distribution facilities in Singapore would cost a further SG$750,000 for the property and required leasehold improvements. This payment was also due at the end of September 2019, when CSPub would take possession. Thanks to the distribution agreement, the Chinese partner would take care of collecting the fees from customers in China and Asia. The payments to CSPub would be in Singapore dollars, regardless of the currency of sale.

Looking at the financial markets, Singh pulled together the relevant information on exchange rates and interest rates (see Exhibits 3–9). She saw that the Canadian dollar–Singapore dollar exchange rate was volatile: 5 per cent swings were the average, and swings in some years were even larger. Since she had information on the forward rates but not on the Singapore dollar–US dollar option market, she called her bank and was given a price for a six-month option of 1.5 per cent of the Canadian dollar amount she wanted to cover in Singapore dollars, converted at the current Canadian dollar–Singapore dollar exchange rate.

Outlook for the Global educational material and Publishing Industry

The industry was forecasted to grow globally at a compound annual growth rate (CAGR) of 1 per cent over the period from 2019 to 2024. Digital technology was allowing an increase in the number of service providers, making the market more competitive than ever. Within the main publishing categories of children’s books, educational and professional books, leisure and lifestyle books, and other, educational and professional materials was one of the fastest-growing segments. Small service providers with custom offerings were growing even faster, with an expected 17 per cent CAGR over the period from 2019 to 2024. The Asia-Pacific market was viewed as the fastest growing, with a 2 per cent CAGR over the forecast period. Due to this region’s higher growth rate relative to the rest of the world, many publishers were working to set up partnerships that would allow them to benefit from this growth.[[3]](#footnote-3)

Global Economy: the North American Outlook

Overall economic growth was viewed as being in transition in 2019, and the North American economy was seen to be in the late stages of a business cycle. Global economic growth was believed to have peaked in 2018, and moderate growth was anticipated for 2019 and 2020. The US economy was expected to slow down from its current fast growth over the next two years. Canadian economic growth was also expected to slow, from close to 2.0 per cent in 2018 to 1.3 per cent and 1.5 per cent in 2019 and 2020, respectively.[[4]](#footnote-4)

The forecast for the Canadian dollar for 2019 and 2020 was tied to changes in commodity prices and the differential in short-term interest rates between Canada and the United States. Commodity prices were expected to rise in early 2019, but faced headwinds from slower global growth in 2020. Meanwhile, little change was expected in the spread on US and Canadian interest rates.[[5]](#footnote-5) Consequently, the Canadian dollar was expected to fluctuate in a range of US$0.75–$0.78[[6]](#footnote-6) over the forecast horizon. The factors affecting the Canadian dollar’s relative strength were related to the global economy. It was believed that the Canadian dollar would weaken if the global economy faltered, but that the US dollar would fall relative to most currencies if global risks did not arise.[[7]](#footnote-7)

Global Economy: East Asia

Expectations for short-term growth in East Asia remained “solid,” according to a United Nations report, which noted strong “domestic demand and accommodative policies.”[[8]](#footnote-8) However, the report went on to say that export growth was “likely to slow, amid elevated trade tensions between China and the United States,” leading to projections of regional gross domestic product (GDP) growth of only 5.5–5.8 per cent between 2018 and 2020.[[9]](#footnote-9) The report noted that growth in China was

projected to moderate gradually. The imposition of tariffs from the United States will dampen exports, while ongoing economic rebalancing measures will weigh on industrial sectors. Nevertheless, the recent easing of monetary policy and the introduction of several pro-growth measures will support domestic demand in 2019–20. . . .

Downside risks to East Asia’s growth outlook have increased considerably. A further intensification of trade frictions will have adverse spillovers on regional growth through trade, investment, and financial channels. An abrupt tightening of monetary policy in the United States may trigger large capital outflows from the region, posing a risk to financial stability. On the domestic front, financial sector vulnerabilities, particularly high corporate and household debt, will continue to weigh on several countries.[[10]](#footnote-10)

CSPub’s Global Operations

With almost 100 per cent of CSPub’s work force currently located in Canada, the new operations in Singapore would create a sizable change in the firm’s cost structure. Up to this point, CSPub had mainly worked with US dollar and Canadian dollar inflows and Canadian dollar outflows (see Exhibits 1 and 2). The new operations in Singapore would add Singapore dollar costs and revenues. CSPub’s contribution to CSP’s net revenue was $8.5 million; in fiscal year (FY) 2018, this included US$2.9 million, which was converted to $3.8 million using the Bank of Canada’s month-end exchange rates, as most payments were made at the end of the month. The profits from CSPub’s total sales were $1.8 million, of which $1.1 million was attributed to the US sales. For CSPub, these US dollar sales led to a realized foreign exchange loss of $182,905. Due to the nature of the business, the accounts payable and accounts receivable were both very small: $31,523 for accounts receivable and $12,967 for accounts payable.

The new operations in Singapore would change the sales and net income numbers, but the agreements would not affect accounts receivable or accounts payable. Sales from the Asian distribution agreement were expected to be similar to the total US-based sales within three years and to grow moderately afterward.

With the new exposure to the Singapore dollar, Singh wanted to better understand this currency.

THe Singapore Dollar[[11]](#footnote-11)

The Singapore dollar, the currency of the island state of Singapore, was monitored by the Monetary Authority of Singapore, and all Singapore dollars in circulation were fully backed by Singapore’s foreign reserves. Singapore ranked among the world’s top five financial centres and was a major trading hub due to its free market economy and corruption-free environment. Singapore’s economy, which depended heavily on exports, was characterized by strong GDP growth and low inflation.

Until the early 1970s, Singapore had pegged its dollar to the British pound; it then briefly pegged it to the US dollar. From 1973 to 1985, Singapore pegged its currency against a fixed but undisclosed trade-weighted basket of currencies. Since 1985, the Singapore dollar has floated within an undisclosed band against the US dollar. Because of the significant relationship between the Singapore dollar and the US dollar, Singh examined the correlation between the Singapore dollar–US dollar exchange rate and the Canadian dollar–US dollar exchange rate (see Exhibit 7).

the Hedging Decision

It was now up to Singh to estimate the type and magnitude of currency exposure she expected CSPub, and therefore CSP, to face in the future. With this information, she could then estimate the value of using different hedging instruments and hedging strategies to manage each risk. To understand the magnitude of the risks, she could consider the impact of a change in the Canadian dollar–Singapore dollar exchange rate that would be accurate to within plus or minus 5 percentage points in any given year.

Based on all of this information, she needed to propose both short-term and long-term courses of action that could be approved and initiated before CSP proceeded too far into the next fiscal year.

Exhibit 1: Income Statement for Canada Specialization Providers, 2015–2018

(in CA$ millions)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **FY 2015** | **FY 2016** | **FY 2017** | **FY 2018** |
| Revenue | 60.95 | 61.14 | 62.82 | 60.09 |
| Cost of Goods Sold | 36.57 | 34.85 | 35.81 | 33.65 |
| Gross Profit | 24.38 | 26.29 | 27.01 | 26.44 |
|  |  |  |  |  |
| Selling General & Admin. Expenses | 20.11 | 18.95 | 18.85 | 17.73 |
|  |  |  |  |  |
| Depreciation & Amortization | 1.52 | 1.53 | 1.57 | 1.50 |
| Other Operating Expense/(Income) | 2.25 | 2.20 | 2.26 | 2.10 |
|  |  |  |  |  |
| Other Operating Expenses, Total | 23.89 | 22.68 | 22.68 | 21.33 |
|  |  |  |  |  |
| Operating Income | 0.49 | 3.61 | 4.33 | 5.11 |
|  |  |  |  |  |
| Interest Expense | (0.73) | (0.66) | (0.69) | (0.70) |
| Interest and Investment Income | 0.06 | 0.04 | 0.03 | 0.05 |
| Net Interest Expenses | (0.67) | (0.62) | (0.66) | (0.65) |
|  |  |  |  |  |
| Income Tax Expense | 0.12 | 0.90 | 1.00 | 1.07 |
|  | | | | |
| Net Income to Company | (0.30) | 2.09 | 2.68 | 3.38 |

Note: FY = fiscal year

Source: Case writer estimates.

Exhibit 2: Balance Sheet for Canada Specialization Providers, 2014–2017

(in ca$ millions)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Dec. 31, 2014 | Dec. 31, 2015 | Dec. 31, 2016 | Dec. 31, 2017 |
| ASSETS |  |  |  |  |
| Cash and Equivalents | 17.48 | 5.28 | 5.86 | 4.81 |
| Short-Term Investments | 0.36 | 0.38 | 0.48 |  |
|  |  |  |  |  |
| Accounts Receivable | 12.39 | 12.80 | 12.36 | 12.68 |
| Other Receivables | 6.12 | 6.37 | 6.31 | 6.04 |
| Notes Receivable | 0.11 | 0.11 | 0.11 | 0.11 |
|  |  |  |  |  |
| Inventory | 5.59 | 5.78 | 6.48 | 6.00 |
| Prepaid Expenses | 3.06 | 2.09 | 2.16 | 1.96 |
| Other Current Assets | 0.90 | 1.19 | 1.04 | 2.65 |
| Total Current Assets | 46.01 | 34.00 | 34.80 | 34.25 |
|  |  |  |  |  |
| Gross Property, Plant, & Equipment | 17.95 | 18.64 | 20.44 | 16.90 |
| Accumulated Depreciation | (10.33) | (10.24) | (10.58) | (9.58) |
| Net Property, Plant, & Equipment | 7.62 | 8.40 | 9.86 | 7.32 |
|  |  |  |  |  |
| Long-Term Investments | 2.11 | 2.15 | 1.96 | 1.95 |
| Goodwill | 16.19 | 17.40 | 19.19 | 18.56 |
| Other Intangibles | 8.85 | 10.45 | 14.03 | 12.53 |
| Loans Receivable, Long-Term | 0.64 | 0.69 | 0.74 | 0.68 |
| Deferred Tax Assets, Long-Term | 1.90 | 1.98 | 2.49 | 2.24 |
| Total Assets | 83.32 | 75.07 | 83.07 | 77.53 |
|  |  |  |  |  |
| LIABILITIES |  |  |  |  |
| Accounts Payable | 16.45 | 17.02 | 16.17 | 14.39 |
| Accrued Expenses | 2.45 | 2.29 | 2.52 | 2.69 |
| Short-Term Borrowings |  | 3.16 | 3.99 | 2.13 |
| Current Portion of Long-Term Debt | 8.05 | 1.72 | 2.58 | 6.14 |
| Current Income Taxes Payable | 4.33 | 4.39 | 4.30 | 4.31 |
| Unearned Revenue, Current | 3.44 | 2.07 | 2.50 | 1.87 |
| Other Current Liabilities | 6.87 | 6.12 | 6.38 | 7.25 |
| Total Current Liabilities | 41.60 | 36.79 | 38.46 | 38.83 |
|  |  |  |  |  |
| Long-Term Debt | 6.17 | 10.23 | 15.19 | 10.35 |
| Pension & Other Post-Retirement Benefits | 1.17 | 1.55 | 1.42 | 1.66 |
| Deferred Tax Liability, Non-Current | 2.45 | 2.89 | 3.54 | 3.26 |
| Other Non-Current Liabilities | 2.66 | 2.70 | 3.04 | 3.02 |
| Total Liabilities | 54.05 | 54.23 | 61.72 | 57.18 |
|  |  |  |  |  |
| Common Stock | 8.00 | 8.00 | 8.00 | 8.00 |
| Additional Paid-In Capital | 8.55 | 0.72 | 0.54 | 0.46 |
| Retained Earnings | 13.07 | 0.41 | 0.74 | 1.75 |
| Treasury Stock | (1.63) | (1.41) | (1.18) | (1.05) |
| Comprehensive Income and Other | 0.50 | 12.13 | 11.85 | 9.86 |
| Total Common Equity | 28.49 | 19.85 | 19.95 | 19.02 |
|  |  |  |  |  |
| Minority Interest | 0.78 | 0.99 | 1.40 | 1.33 |
|  |  |  |  |  |
| Total Liabilities and Equity | 83.32 | 75.07 | 83.07 | 77.53 |

Source: Case writer estimates.

Exhibit 3: Financial Market Data from March 29, 2019

|  |  |  |  |
| --- | --- | --- | --- |
|  | **March 29, 2019** | | |
| Rate | CA$–US$ | SG$–US$ | CA$–SG$ |
| Spot | 1.3346 | 1.3557 | 0.9844 |
| 3-month forward | 1.3312 | 1.3534 | 0.9836 |
| 6-month forward | 1.3255 | 1.3467 | 0.9843 |
| 12-month forward | 1.3167 | 1.3415 | 0.9815 |

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Average Last 12 Months**  **(Minimum/Maximum)** | | |
| Rate | CA$–US$ | SG$–US$ | CA$–SG$ |
| Spot | 1.3121 (1.3639 ÷ 1.2548) | 1.3581 (1.3856 ÷ 1.3092) | 0.9661 (1.0001 ÷ 0.9327) |
| 3-month forward | 1.3095 (1.3624 ÷ 1.2525) | 1.3554 (1.3826 ÷ 1.3058) | 0.9663 (1.0012 ÷ 0.9327) |
| 6-month forward | 1.3034 (1.3561 ÷ 1.2486) | 1.3459 (1.3725 ÷ 1.2972) | 0.9685 (1.0049 ÷ 0.9325) |
| 12-month forward | 1.2963 (1.3492 ÷ 1.2406) | 1.3359 (1.3630 ÷ 1.2886) | 0.9704 (1.0121 ÷ 0.9380) |

|  |  |  |  |
| --- | --- | --- | --- |
|  | **March 29, 2019** | | |
|  | Canada | Singapore | United States |
| 3-month deposit rate | 1.85 | 1.80 | 2.60 |
| 6-month deposit rate | 1.94 | 1.94 | 2.65 |
| 12-month deposit rate | 2.15 | 2.07 | 2.71 |
|  |  |  |  |
| 6-month BBB lending rate | 3.34 | 3.34 | 4.05 |

Note: SG$ = SGD = Singapore dollar

Source: Created by the case author using data from DataStream Economic Fundamentals database, accessed June 6, 2019.

Exhibit 4: Exchange Rates, US$ per CA$ and US$ per SG$, 2004–2019

Note: SG$ = SGD = Singapore dollar

Source: Created by the case author using data from DataStream Economic Fundamentals database, accessed June 6, 2019.

Exhibit 5: Purchasing Power Parity (PPP) for CA$ and SG$ compared with US$,  
1990–2016

Note: SG$ = SGD = Singapore dollar

Source: Created by the case author using data from DataStream Economic Fundamentals database, accessed June 6, 2019.

Exhibit 6: US$, CA$, and SG$ Interest Rates, 2004–2019

Note: SG$ = SGD = Singapore dollar

Source: Created by the case author using data from DataStream Economic Fundamentals database, accessed June 6, 2019.

Exhibit 7: CA$–US$ to SG$–US$ Correlation, 2010–2019

Note: SG$ = SGD = Singapore dollar

Source: Created by the case author using data from “USDSGD (US Dollar vs Singapore Dollar) – USDCAD (US Dollar vs Canadian Dollar) Correlation,” MyFXBook, accessed May 8, 2019, www.myfxbook.com/en/forex-market/correlation/USDSGD-USDCAD.

Exhibit 8: 3-Month, 6-Month, 12-Month, and 2-Year Forward Rates for CA$–US$ and SG$–US$, January–April, 2019

Note: SG$ = SGD = Singapore dollar

Source: Created by the case author.

Exhibit 9: Inflation rates for Canada, United States, and Singapore, 2010–2018

Note: SGD = Singapore dollar

Source: Created by the case author.

1. All currency amounts in Canadian dollars unless specified otherwise. [↑](#footnote-ref-1)
2. SG$ = SGD = Singapore dollar; SG$1 = US$0.7382 as of March 31, 2019. [↑](#footnote-ref-2)
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9. Ibid. [↑](#footnote-ref-9)
10. Ibid. [↑](#footnote-ref-10)
11. OANDA Corporation, “Singapore Dollar, accessed December 6, 2019, <https://www1.oanda.com/currency/iso-currency-codes/SGD>. [↑](#footnote-ref-11)