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MOLTO DELIZIOSO: PRICING AND PROFITS FOLLOWING BREXIT DEVALUATION

Sitting in his office overlooking St. Paul's Cathedral in January 2016, Nigel Montague appeared the picture of contentment. Montague was the managing director of the U.K. subsidiary of a parent company, Molto Delizioso, SRL, an Italian maker of coffee machines. Molto Delizioso coffee machines carried a cachet that coffee enthusiasts in London and other major British cities were willing to pay £200[1] for. Molto Delizioso faced fierce competition from other coffee makers, such as those produced by De'Longhi, Cuisinart, Philips, and Fracino, and Montague was concerned about the price sensitivity of consumers in the U.K. market. However, while the exchange rate favoured the pound over the euro, Montague was content to see his U.K. subsidiary reporting good-enough profits to the Milan headquarters of Molto Delizioso (see Exhibit 1).

Montague's contact in the Conservative (Tory) Party had assured him that the upcoming referendum on the United Kingdom's withdrawal from the European Union (EU), or Brexit, would surely result in a vote to remain. By early June 2016, however, Montague's earlier confidence had evaporated and he had become anxious. What if the Brexit vote resulted in a decision for the United Kingdom to leave, and the pound were devalued? "We have to pay for the machines in euros," he told himself, "but sell in the U.K. market in pounds."

THE CONTEXT

Many items sold in the U.K. market, such as the Molto Delizioso coffee machines, were imported and paid for in euros, but when these items were sold by the U.K. subsidiary, the revenue earned was in pounds. Foreign subsidiaries of multinational firms often purchased products or components from their parent companies and paid for the imports in the parent's currency, but then sold the items in the subsidiaries' local currencies. Such intrafirm trade was very common.[2] According to the United Nations Conference on Trade and Development, a multinational company was involved as either the importer or the exporter in 80

[1] £ = GBP = United Kingdom pound; € = euro; currency amounts are in £ unless otherwise specified; US$1.00 = £0.77 on July 6, 2016; US$1.00 = €0.90 on July 6, 2016.
[2] David Turner and Pete Richardson, "The Global Business," *Organisation for Economic Cooperation and Development, The OECD Observer* 234 (2002): 27, accessed October 2016, http://oecdobserver.org/news/archivestory.php/aid/850/The_global_business_.html.

per cent of world trade.[3] In general, when costs were in one currency but revenues were in another, any change in the exchange rate could affect both parties and therefore alter the profit of the operation. This situation was faced by hundreds of thousands of firms worldwide.

JUNE 2016: BREXIT AND DEVALUATION OF THE POUND STERLING

The June 23, 2016, referendum and the decision of U.K. voters to leave the European Union precipitated a devaluation of the pound sterling. On June 24, the day after the Brexit vote, the pound fell by almost 8 per cent, and by July 6, it had dropped further, to €1.16. That afternoon, Montague received a frantic phone call from Umberto Galeazzi in Molto Delizioso's Milan headquarters: "Nigel, what are you going to do about our declining profits from your U.K. subsidiary? We need a strong answer, with your plans, by the beginning of the next fiscal quarter!"

Dabbing his forehead, Montague could offer only a weak promise to commission additional market research over the next two months and get an answer to his Italian headquarters by September 2016.

After the post-Brexit devaluation of the pound, one option for British importers was to leave the local selling price in pounds unchanged; however, that decision would reduce profits because the import costs in pounds were going up. An alternative strategy used by many major importers was to increase prices in pounds per unit in the U.K. market to make up for the higher post-devaluation costs.[4] This alternative strategy could be better for profits, or not, depending on the reaction of U.K. customers to price increases—or their price elasticity of demand.[5] This reaction in turn depended on the intensity of competition in the market for similar products. Turning to his spreadsheets, Montague saw what the numbers had looked like in happier days (see Exhibit 1).

MONTAGUE'S DILEMMA: KEEP PRICE PER COFFEE MACHINE THE SAME, OR INCREASE IT?

Montague learned from fellow members at his Argyll & Cummerbund Club, who faced a similar import situation, that their post-Brexit numbers ranged somewhere between sobering and horrifying. "It all depends on how the damned buyer reacts," opined Sir Colin Chelmsford, who headed a U.K. company that imported German wines. "If I keep my price per bottle the same in pounds while my costs go up because the pound has been devalued against the euro, my profits shrink. But if I raise my price, volume will suffer."

Chelmsford then quickly added, "But who knows? Raising prices may improve profits over keeping prices the same."

"In my situation," Montague interjected, "there is an added complication. The pound sterling profits of my subsidiary have to then be converted back into euros, and that's the picture that Milan headquarters really cares about."

On his way home from a sombre dinner at the club, Montague reviewed his options. Should he keep the price per coffee machine the same, or should he increase it? "I had better commission a quick market study and get a report from a marketing consultancy," he decided.

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[3] United Nations Conference on Trade and Development (UNCTAD), "Global Value Chains: Investment and Trade for Development," chapter IV in *World Investment Report 2013*, June 2013, accessed October 2016, http://unctad.org/en/PublicationChapters/wir2013ch4_en.pdf.
[4] Saabira Chaudhury, "Unilever Price Rises Herald Brexit Pain for British Consumers," *Wall Street Journal*, October 13, 2016, accessed February 27, 2017, www.wsj.com/articles/unilever-raises-prices-to-maintain-sales-1476340026.
[5] "Price Elasticity of Demand," Investopedia, accessed February 27, 2017, www.investopedia.com/terms/p/priceelasticity.asp.

THE CONSULTANT'S REPORT: TWO MONTHS LATER

Montague saw that he might be forced to raise prices for the coffee machines in the U.K. market. He decided to try increasing the price from the current £200 to £235 per unit. This change would be a 17.5 per cent increase—roughly the same percentage as the pound's devaluation against the euro. "It's not very scientific," Montague thought to himself, "but at least it will show Milan headquarters that I am taking some action."

In late September 2016, the consultants at Veraccurate Research Associates (VRA), Pvt. Ltd. submitted their opinion to Montague, saying, "We find that your profit picture varies significantly, depending on the price elasticity of your customers."

Grumbling under his breath, Montague told himself he knew that already, but then he replied: "All right. What does your market survey say about customers' elasticity?"

The VRA consultant explained in reply:

> The elasticity number is only 0.8 if we assume that all importers of Continental Europe-made coffee machines will also raise their prices. But if we assume that some importers will not raise their unit price in pounds—and this may also be true of Fracino, a U.K. producer despite its Italian-sounding name—then our research suggests that the elasticity number would be 1.1 for your machines.

As a reminder, the VRA consultant displayed on his screen the simple formula for price elasticity that had been used in recalculating the income statement:

$$Price\ Elasticity = \frac{\%\ Change\ in\ Quantity\ Demanded}{\%\ Change\ in\ Price\ per\ Unit}$$

Montague and the consultant then reviewed spreadsheets showing the income statements of Molto Delizioso (U.K.) under three alternative assumptions:

- Keep the price the same: £200
- Increase the price to £235, assuming price elasticity $\varepsilon = 0.8$
- Increase the price to £235, assuming price elasticity $\varepsilon = 1.1$

Squinting at the screen, Montague anxiously awaited the results for his subsidiary's profits under the three alternate assumptions the consultants had come up with.

EXHIBIT 1: PRE-BREXIT INCOME STATEMENT (ANNUALIZED), ASSUMING £1.00 = €1.36

	Per Unit	**Quantity (Units)**	**€**	**£**
Sales in U.K.	£200	40,000		8,000,000
U.K. Costs				
• Contract Labour (variable cost)				200,000
• Import of Coffee Machines (invoiced at €90 each)	€90	40,000	€3,600,000	2,647,059
• Marketing and Distribution Costs (assumed to be fixed costs)				400,000
• Other Fixed Costs: Overheads, Interest, Depreciation, Rent, Salaries, etc.				500,000
Profit (U.K. Subsidiary)				£4,252,941 Or €5,784,000

Source: Company documents.