

Report on Foreign Exchange Risk Management Solutions-The Walt Disney Company's Financing

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Abstract:

In order to solve special foreign exchange risk problems, this report takes Walt Disney Company as a typical example. It first collects global foreign exchange data in 1985 comprehensively, then discusses the advantages and disadvantages of ordinary hedging tools including forwards, futures, and options in financial risk management. What's more, it also deeply analyzes the benefits of the special method of swap trading when foreign exchange risks occur, exploring how swap transactions can better match the long-term and complex risk exposure of enterprises. The study found that Goldman Sachs' method, which involves issuing ten-year ECU euro bonds and converting them into yen liabilities through currency swaps, can effectively avoid the shortcomings of ordinary hedging tools. It not only successfully solves the problem of foreign exchange risks, but also provides a valuable reference for enterprises to face risk management in the future, especially for multinational companies dealing with cross-currency and long-term financial risks.

Keywords: Risk management; Hedging tools; Exchange rates.

1. Introduction

In the 1980s, under the background of the rapid development of the global economy, the financial situation of many enterprises became better dramatically. And transnational transactions began to gradually develop. Influenced by the pursuit of economies of scale and the acquisition of diversified resources, multinational companies have gradually occupied a large part of the transaction revenue. Naturally, enterprises started to extend their business to all over the world. As one of many multinational enterprises,

the Walt Disney company has developed Disneyland business in Japan. The reason is that the Japanese economy was in a prosperous stage at that time, and consumer demand was strong. However, with the increasing frequency of international transactions, Disney faced an increasingly complex risk of exchange rate fluctuations. In terms of exchange rate risk management, a large number of literatures have made in-depth research on this field. Aabo analyzes the potential and actual exchange rate exposure strategies of industrial enterprises in determining and optimizing hedging strategies[1]. Dha discusses

how British listed companies manage exchange rate risks, which mentions three different methods, including the use of hedging tools to solve different problems[2]. The article of Steven M. lists the nature of foreign exchange risk and the methods of collecting foreign exchange data[3]. Weithers provides an overview and introduction of options[4]. Ahn & Boudoukh & Richardson & F. Whitelaw analyze how to minimize the risk value with options and provided an analytical solution in their article [5]. Allen discusses the key to financial risk management in the book[6]. Fraser & Simkins introduce risk management and studied how enterprises can use forward products for risk management[7]. Broll uses a cross-period model to study the impact of exchange rate risk on multinational companies in the book[8]. Eyinade et al. search how to manage risk in energy investment in their journal[9]. In addition, Badhan et al. discuss the strategies to mitigate the adverse effects of exchange rate fluctuations[10]. Lestari & Adekunle emphasize systematic factors that affect foreign exchange risks and strategies to mitigate risks[11]. Ledwaba et al. investigates the impact of exchange rate fluctuations on banks during the special period of COVID-19[12]. These studies have proposed relatively in-depth solutions and insights into the financial risk management and challenges encountered by companies in transnational transactions. However, there is a special situation in Disney. Because the Reagan administration was implementing the economic policy of "strong dollar", the exchange rate of the US dollar against the Japanese yen continued to fluctuate sharply. In the end, this policy led to a dramatical decrease in Disney's final dollar revenue, seriously threatening Tokyo Disney's profit stability. Goldman Sachs has given a special solution through a specific analysis of classic hedging tools - swap trading, thus reducing the negative impact of exchange rate fluctuations. This analysis of the case helps to improve the company's response to risk management, guide the decision-making of multinational enterprises in exchange rate risk management and reduce the negative impact.

2. Disney's exchange rate risk management

2.1 The Walt Disney Company

The Walt Disney Company is a diversified international company located in California founded in 1938. Its main business industries include entertainment industry including television, real estate projects. The company's popularity attracts the Tokyo Disneyland to do the investment and pay royalties in Japanese yen, which has increased Disney's total entertainment and leisure revenue by 6%. But Tokyo Disney also brought exchange rate risks to the

Walt Disney company at the same time.

2.2 The situation of exchange rate risk

The increase in Tokyo Disney's yen revenue has made Disney's financial director face a crucial challenge: the fluctuation of the yen/dollar exchange rate. Because the depreciation of nearly 8% of the yen will have a significant negative impact on Disney's revenue[13].

2.3 Problems

2.3.1 Foreign exchange exposure risk

Although Walt Disney's opening and Japanese yen royalty income from Tokyo Disneyland has gradually increased, reaching 8 billion yen in 1984, the yen depreciated significantly in 1985 with a trend of declining value. This negative exchange rate fluctuations may cause US dollar income decrease dramatically.

2.3.2 The proportion of short-term debt is too high

In 1984, because of the acquisition of Arvida and the repurchase of shares from Reliance Insurance Company, Disney generated huge expenses of \$862 million. In 1984, the ratio of Disney's debt to total capital jumped from 20% to 43% at the end of the previous fiscal year. Although it has since dropped to 32%, there is still a problem that the ratio is too high. More importantly, two-thirds of Walt Disney's loans are short-term bank loans and commercial paper with relatively high interest rates, which will make Walt Disney's repayment pressure too concentrated, lack of enough funds to support repayment, and lose the flexibility of cash flow.

3. Ways to manage the exchange rate risks

In the face of these exchange rate risks, some hedging tools begun to be used to solve this problem. After a series of analysis, Disney found that traditional hedging tools include options, futures, forwards and foreign exchange swaps have shortcomings that cannot be ignored. Finally, Goldman Sachs cooperated with Disney and gave a special solution. This report will analyze the risks of Walt Disney and discuss the rejected and accepted solutions.

3.1 Forwards

A forward contract refers to selling forward Japanese yen in the forward market. Its advantage is that it doesn't require a complex trading mechanism, that means both parties can directly reach an agreement and conduct transactions. But Disney's such behavior is risky, because forwards are generally traded over the counter, thus occupying valuable credit limit. Additionally, the duration

of forward contracts is often too short (less than 2 years), which does not meet Disney's needs for solving this problem.

3.2 Options

Using options is also a positive way to overcome this challenge by buying put options in Japanese yen. The advantages are low cost and controllable risks. First, low cost means the buyer only needs to pay a small amount of premium to obtain the relevant rights. Secondly, as an option buyer, Disney's biggest loss is only the paid rights, so it has controllable risks. However, it still has the disadvantage of short duration.

3.3 Futures

Futures contract is also an effective hedging tool. Compared with forwards, this solution bears less risks. Because futures are often traded in the market, which means it has the intervention of a third party, then efficiently guarantee the security of trading. However, the problem is that its liquid market only exists for two years or shorter, making Disney unable to avoid long-term risks and debts.

3.4 Foreign currency swap

As an alternative, Disney can conduct a foreign currency swap to convert its existing U.S. dollar liabilities into yen liabilities. In this way, Disney can avoid the negative impact of yen income as much as possible in the case of yen

depreciation. But this hedging method is also short-term because Disney's Eurodollar note issues mature within one to four years. Plus, it is difficult to find attractive yen swap rates that less than four years. Additionally, this method will not provide Disney with more cash, which is not beneficial to Disney's repayment of its short-term debts.

3.5 Create yen liability

Creating yen liabilities through loans or bonds is also a way to cope with risks. In terms of loans, although they are legal and compliant, there is a problem of high costs. Because this method will not be applicable when the company's debt ratio is high. In terms of bonds, it is good because Eurobonds exist in the free market with a long duration and reasonable prices. However, their fatal weakness is they are not allowed by the Japanese Ministry of Finance, so Disney is not allowed to issue Euro-yen bonds at all.

Table 1 outlines the advantages and disadvantages of different regular hedging tools in this case. From this, enterprises can fully know the benefits and drawbacks of each hedging tool to select the most suitable and efficient method. Take for an example, if a company wants to establish a long-term risk management strategy, the first four tools in the table will not be given priority because of their short-term nature.

Table 1. Features of ordinary hedging tools

Tools	Pros	Cons
Forwards	Easy trading mechanism	Occupy the credit limit/short term
Futures	High liquidity/No counter-party risk	Short term
Options	Low cost/controllable risks	Short term
Dollar/yen swap	Avoid exchange rate risks	Short term/unattractive swap rates
Create yen liability through loan/bond	Loan: Legal/compliant Bond: Cheap/long term/free	Loan: Too expensive Bond: Not allowed by the regulations

3.6 Goldman Sachs' special solution - issue ten-year European currency unit euro bonds and convert them into yen liabilities through swaps

Goldman Sachs suggested that Walt Disney Company can issue ten-year bonds of 80 million ECU with a coupon price of 100.25% of the face value, a coupon interest rate of 9.125%, and an underwriting fee of 2%. In terms of currency swaps, the Industrial Bank of Japan (IBJ) acts as the third party to arrange the exchange of ECU and US dollars. The steps are Disney gives the net income of ECU European bonds to IBJ, and then IBJ pays Disney in Eu-

ropean currency units that exactly match the coupon and principal of Eurobonds. At the same time, Disney receives Japanese yen from IBJ, which is equivalent to the net income of ECU and ECU bonds. Finally, Disney can convert such yen earnings into US dollars and reduce short-term borrowing. This solution solves the problems of insufficient long-term hedging and inability to increase cash flow, which have not been solved by traditional hedging tools. In addition, there are three reasons for using this method: Firstly, this plan has the advantage of low cost. The cost of Goldman Sachs' plan is far lower than that of direct yen loans, and it achieves lower-cost yen financing

through ECU bond issuance interest rates and currency swaps. Secondly, the debt needs of the Walt Disney company and French utilities are matched. Disney needs long-term Japanese yen liabilities to hedge exchange rate risks, while French utilities hold a large number of Japanese yen debt that want to be converted into ECU liabilities. After the exchange through the third party IBJ, the needs of these two companies are perfectly met. Thirdly, this method effectively avoids the restrictions of law. According to the requirements of the Ministry of Finance of Japan, Japanese companies cannot directly issue euro-Japanese yen bonds. In this way, Disney can bypass Japan's restrictions and complete debt risk management through "ECU bonds + currency swaps".

4. Case insights

The analysis of hedging tools enables enterprises to better match different risks with appropriate hedging tools according to their own circumstances, helping enterprises minimize risks more effectively. Different hedging tools are suitable for different types of risks, and enterprises should make judgments based on the actual situation. In general, judging whether hedging tools can effectively solve risks and problems is mainly judged by the risk cycle, cost and flexibility.

4.1 Risk types suitable for Forwards - short-term interest rate risk

The trading mechanism of Forwards is relatively simple, which is convenient for enterprises to quickly manage risks. However, the general contract term of forwards is within one year, which can only cover short-term risk exposures and long-term hedging needs that cannot be met for more than one year. Therefore, it is more suitable for enterprises to manage short-term risks.

4.2 Risk types suitable for futures - short-term interest rate risk

Similar to forwards, the maturity of futures is generally within one year, up to two years. There are too few long-term option varieties, so they are only suitable for short-term risk hedging by enterprises. In addition, the high liquidity of futures enables enterprises to liquidate through exchanges, and the cost of capital occupation can be greatly reduced.

4.3 Risk types suitable for options - short-term interest rate risk

Similarly, common option contracts are usually only maintained for a few months. In addition, long-term options for more than one year not only are there few types of contracts, but they also need to bear a huge option fee,

which is not conducive to the control of costs by enterprises. Therefore, options are not suitable for enterprises with long-term risks, but more suitable for companies with short-term risks. Because in the case of hedging short-term risks, enterprises can not only sign contracts at an appropriate time, but also only need to pay a fixed option fee, which guarantees the upper limit of hedging costs.

4.4 Risk types suitable for foreign currency swap - medium and short-term cross-border exchange rate risk

Most of the contracts for foreign exchange swaps are from one to three years, and a few can reach five years. Using this method, you can directly realize hedging by exchanging different currencies, which can more effectively avoid cross-border exchange rate risks. But this may mean that enterprises may need to accept a swap interest rate higher than the market average to conclude a deal, raising the cost of hedging.

4.5 Risk types suitable for create liability with bond/loan - long-term interest rate risk

Most loans and bonds have a term of three to five years, and a few enterprises can even get ten years. This is very beneficial to enterprises holding long-term interest rate risks. However, compared with low-cost bonds, the core feature of loans is their high cost, resulting in significantly higher cost of funds than other hedging instruments.

5. Conclusion

This research on foreign exchange risk management solutions highlights the problems of term and cost of traditional hedging tools. Goldman Sachs' ten-year European currency euro bond and debt swap can solve the problem of long-term hedging insufficiency and inability to increase cash flow. Additionally, research shows that when facing different situations in the international capital market, people should consider different factors and observe the different needs of various companies in the international market to come up with the best plan. For instance, multinational companies with extensive global operations may pay more attention to the long-term stability of cash flow, but small enterprises engaged in cross-border trade may pay more attention to short-term transaction risks. Walt Disney's risk management of the company's yen income under the depreciation of the yen reflects the limitations of traditional hedging tools. The plan proposed by Goldman Sachs perfectly solves the different problems of the two companies. It not only solves the problems encountered by Disney in the face of the risk of yen depreciation but also meets the debt conversion needs of French utilities, which has also let it become a model reference for many

companies' financing and management. However, the shortcoming of this study is that it only analyzes the risk management of Disney in a specific period. In future research, it can be expanded to more enterprises and analyze the methods of risk management under different economic conditions.

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