Case on derivatives

By Dr. Ridhi Khattar

Ankit Garg, 32 years, is a Delhi University commerce graduate and have done his masters in management from IIM Lucknow. He worked in a MNC as a Product Manager for 4 years before joining his family business last year. The company was started by his father, Anil Garg, and his 2 brothers, Ashish and Aman Garg, 25 years back with the name “Garg Brothers & Co” and was into export of handicrafts. They used to purchase the handicrafts from craftsmen in different parts of Rajasthan and export it to countries in Europe where there was huge demand for Indian Handicrafts. The philosophy of their business was to nurture relationships with the clients as well as the craftsmen. They used to ensure that they fulfill their commitments to them and support them in their tough times as well. Because of this approach, they were able to retain their clients and have long run association with the craftsmen. The business has grown over the years and is able to generate an annual profit of more than Rs. 25 crore which get distributed amongst the 3 brothers.

Their business is quite stable in terms of demand for the product but the only thing that concern them is the fluctuation in the currency. They make the payment to the craftsman in Indian Rupees(INR) while the receipts from the European clients is in US Dollars(USD).

Last month they received an order from one of their regular client ‘Kathy’ in Netherland for export of handicrafts worth USD 185000. Anil and his two brothers were thrilled as that means a business of more than Rs 1.2 crore with INR trading at Rs 65.5 per USD. In their business the gross margins are 40% while the net margins are close to 25%. The order has to be delivered in a month time. Accordingly, they contacted the craftsmen and asked them to deliver the handicrafts to them in 15 days time. They received the handicrafts within stipulated time and made the payment to the craftsmen. Then the packaging and labeling happened at their workshop and the goods were dispatched a week before so that they reach the destination on time. Kathy will send the payment within 15-20 days of receiving the order. Since, Kathy has been dealing with them from long, they don’t ask for any advance payment from their regular clients.

With Ankit joining the business last year and his cousin, Manish who is son of his uncle Ashish Garg, planning to join the business next year after completing his masters from a university in Australia, there are plans to expand the business of “Garg Brothers & Co”. With an established client base new product lines will be added to cater to the international clients. Some of the products like glass crafts will be procured from China, Iran and Iraq. Ankit has been in touch with the craftsmen in these countries and many of them have given consent to be associated with them on a condition that they will receive 50% of the payment when the order is placed to them and rest 50% on delivery. With the Indian craftsmen they used to give only 25% payment in advance.

In order to promote the new product line, Ankit has designed an International marketing campaign which will cover more than 15 countries in Europe. The expenditure on the campaign will be around 12 crores. They already have more than 5 crores surplus available to commit to the campaign. The payment worth Rs. 5 crore is pending from the clients including Kathy which is expected to come in a month time. The rest 2 crore will be arranged through a bank loan.

Ankit is waiting eagerly for the payments by the clients as he has already applied for the business loan which will be disbursed in a week time and the advertising agencies need to be paid in advance so that the advertisement campaign can commence. While he was looking at the vouchers and books of accounts for the exact payment to be received, he realized that with the current foreign exchange rate which 62.75 he will run short by more than Rs. 20 lakh as the orders were booked when the rate was 65.5. With the INR appreciating further this shortfall might go up. In that scenario, the plans will get adversely affected as then he need to arrange for the additional funds which will be difficult as they need to keep funds for the working capital requirement.

He discussed his concerns with his father and he advised him that this risk is an integral part of their business and in the past also they have suffered losses because of this but nothing can be done about it.

Ankit is now wondering that if foreign exchange movement have such a big bearing on the profitability of their business, cant they do anything to minimize this risk.