

Kilgore Custom Milling

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This case study provides a broad spectrum of issues—both opportunities and potential threats—that arise from creating growth opportunities. Many risks can be explored and debated as part of various approaches to enterprise risk management (ERM), including using strengths, weaknesses, opportunities, and threats (SWOT) analysis and risk profiles. In particular, this case focuses on financial risk management as taught in Chapter 14, “Market Risk Management and Common Elements with Credit Risk Management,” in *Enterprise Risk Management: Today’s Leading Research and Best Practices for Tomorrow’s Executives*, edited by John Fraser and Betty J. Simkins (John Wiley & Sons, 2010). Thus, teachers of ERM can focus at the corporate level and include all risks, or delve more specifically into financial risks, or go even more specifically into liquidity or foreign exchange risks.

BACKGROUND

“Hope is not a risk strategy! Wishful thinking is not the best we can do, and furthermore we can’t repeat the mistakes of the past if we want to move to the next level. We need to think this through more carefully!” Cathy Williams was growing ever more tired and frustrated. She and her four-person treasury team had been struggling with various aspects of the new supply contract for weeks, and all that remained was how the company would hedge the resulting currency risk. This issue had been highlighted as part of the management team’s discussions about risk management generally, and it was still an issue as to how this aspect of currency hedging would fit into the firm’s attempt at creating an enterprise risk management framework. As she sat with her boss, Steve MacLinden, and the rest of the company’s senior management team, it was clear that they were not any further ahead than they had been when the financial hedging strategy meeting began over two hours ago.

Kilgore Custom Milling was a small private manufacturer of power window assemblies for automobile manufacturers’ plants based in southern Ontario,

Canada. Just over a year ago, as part of a strategic planning session, the company made a decision to seek out contracts to supply plants in the United States. Due to the successful efforts of the entire management team, they were in the final stages of finalizing a contract to supply a Japanese car company that was expanding its operations in Michigan. The deal included a possible extension to supply a plant in Tennessee and one in Mexico that would be coming on line in nine months. Supplying plants in the United States was a major move for the company, a move it had tried before but which had produced results that almost bankrupted the company.

The process of securing the contract had been an exhausting exercise. The Japanese manufacturer involved was very thorough in its due diligence of its supplier agreements. Additionally, in the current economic manufacturing environment, the competition was tough. The five-year contract, with an option to extend to eight years, could potentially mean the difference between a supplier such as Kilgore staying in business and it failing. The operational and technical demands of the Japanese manufacturer were high, but the main point of competition was price, as several different suppliers had the necessary track records and operational platforms to satisfy the conditions and standards necessary to win. In the 1990s, Canadian manufacturers such as Kilgore could rely on the relatively weak Canadian dollar to help them win price-based contracts. That advantage was now gone with the Canadian dollar near parity to the U.S. dollar, and thus it was manufacturing ability and geographical placement that were key determining factors—along with the bottom-line pricing, of course.

The prospect of selling to a U.S.-based manufacturer for the first time in almost 25 years was very exciting, but also scary. Kilgore had supplied a U.S.-based plant in the late 1980s for a while, but exchange rate volatility had caused Kilgore trouble and had led to significant losses. As a result, Kilgore made a decision to stick with supplying Canadian-based manufacturers. Many of its competitors in the automotive supply industry continued to focus on supplying the large U.S. manufacturing plants. Over this period of time, the focus on Canadian sales had provided Kilgore with a stable and profitable stream of business. However, with the changing manufacturing strategies of global manufacturers after the 2008 financial crisis, Kilgore needed to rethink its own strategy.

The contract was to be finalized in less than a week, with shipments to begin in six months, but exactly how Kilgore Custom Milling was going to be able to deliver profitably on the contract was still in doubt. To be sure, the operational and manufacturing details were set, but the contract was finely priced based on the competition. Any hiccups in production or in managing the exchange rate risk could turn the five-year, and possibly eight-year, contract into a guaranteed loss for Kilgore.

“Okay, I think we should all take a break for the weekend and tackle this with fresh minds on Monday,” said Steve MacLinden, the CEO and cofounder of the company. “That’s just great,” thought Cathy. “What he really means is that I have to spend the weekend coming up with a solution for first thing Monday!” With that the meeting broke up with pleasantries exchanged for everyone to have a nice weekend—a weekend that Cathy knew she would be spending coming up with a workable plan for managing the currency risk that Kilgore would be taking on with this new phase of the company’s evolution.

KILGORE CUSTOM MILLING

Kilgore Custom Milling began in late 1980. Steve MacLinden and a fellow business school graduate were wondering what sort of a career they should embark on when they came up with the idea of getting into manufacturing. Before earning his MBA, Steve had worked for five years with a major accounting firm. He went back to business school looking for a way to expand his horizons and thinking he wanted to work in marketing for a multinational company. Upon graduation, however, he thought it might be more of an adventure to be his own boss as an entrepreneur. Along with a classmate, Steve began to explore opportunities. With a government grant for young entrepreneurs, monies from an inheritance, and loans from family and friends, the two young men were able to buy a working tool and die company that had 11 employees; it made custom parts for various repair shops and had a few small contracts with various manufacturing companies. Steve was a big fan of the novelist Kurt Vonnegut, so they renamed the company Kilgore Custom Milling after a recurring character who appeared in several Kurt Vonnegut novels.

For the first few years the company struggled and relied on heavy levels of bank debt and personal loans to stay in business. Steve's business school buddy wanted out as a partner and sold his interest to Steve for a single dollar and a release from the debt obligations of the company. By then the workforce was down to four employees on a full-time basis who were supported by the occasional hiring of short-term contract workers when the work orders required them. While the company started to eke out a very modest profit, its long-term viability was far from guaranteed. It was at this point that the company caught a lucky break when a fire at a competing small auto parts manufacturer caused the latter to cease production for two months. Kilgore stepped in and secured a contract to become a short-term supplier of parts required for power windows in automobiles. That contract provided a springboard for further contracts, and soon the operations and business of the company were streamlined to focus solely on power window assemblies for direct supply to several auto manufacturers based in southern Ontario. The company grew to employ 128 workers at the company's two manufacturing facilities and a separate warehouse facility. Recent financial statements for Kilgore are provided in Exhibit 19.1.

The production of power window assemblies was a relatively simple task, and the technology was widely available and considered a commodity. The production of a power window consisted of a small electric motor (which Kilgore purchased from a variety of Canadian suppliers), a support bar on which the glass rode, a series of gears, and a variety of metal and plastic components to ensure smooth operation. See Exhibit 19.2 for an illustration of a power window assembly.

Kilgore became a relatively successful manufacturer in the original equipment manufacturer (OEM) field mainly because of its focus on low-cost manufacturing, which in large part was due to the relatively large pool of skilled manufacturing workers available in the Windsor area of southwest Ontario.

Based in southern Ontario, which was also home to the majority of Canada's OEM industry, Kilgore had ready access to labor and, based on operational efficiencies and a focus on a single product, also had a low cost of manufacturing. Indeed, since power window assemblies were low-tech and considered a

Exhibit 19.1 Kilgore Custom Milling Financial Statements

| INCOME STATEMENT | (CAD MM) | 12/31/12 | 12/31/11 | 12/31/10 | 12/31/09 |
|---|----------|----------|----------|----------|----------|
| Net sales | | 204.8 | 184.8 | 154.6 | 158.4 |
| Costs of goods sold | | 190.1 | 169.4 | 141.0 | 141.3 |
| Selling, general, and administrative expenses | | 8.6 | 8.9 | 7.8 | 8.9 |
| Operating income | | 6.0 | 6.5 | 5.8 | 8.2 |
| Interest expense | | 2.9 | 2.5 | 2.4 | 2.4 |
| Net nonoperating loss (gain) | | 2.3 | 0.0 | 0.0 | 0.0 |
| Income tax expense | | 0.1 | 1.0 | 1.0 | 1.7 |
| Net income | | 0.6 | 3.0 | 2.3 | 4.1 |
| Common dividend (total cash) | | (0.6) | (2.3) | (2.3) | (2.9) |
| Opening retained earnings | | 19.1 | 18.4 | 18.4 | 17.2 |
| Closing retained earnings | | 19.2 | 19.1 | 18.4 | 18.4 |
| CASH FLOW STATEMENT | (CAD MM) | 12/31/12 | 12/31/11 | 12/31/10 | 12/31/09 |
| Operating activities | | | | | |
| Net income | | 0.6 | 3.0 | 2.3 | 4.1 |
| Depreciation | | 5.1 | 4.8 | 4.7 | 4.6 |
| (gain)/loss on fixed asset disposals | | 0.5 | 0.1 | 0.0 | (1.9) |
| Cash from/used for working capital | | 3.7 | (1.5) | 0.1 | (4.6) |
| Cash from operating activities | | 9.9 | 6.5 | 7.2 | 2.2 |
| Investing activities | | | | | |
| Additions to fixed assets | | (6.5) | (3.4) | (1.9) | (1.9) |
| Fixed asset disposal proceeds | | 1.4 | 0.0 | 0.6 | 1.9 |
| Other LT assets | | (13.7) | (3.0) | (10.8) | (4.2) |
| | | (18.8) | (6.4) | (12.1) | (4.1) |
| Financing activities | | | | | |
| Short-term borrowings | | 3.0 | 0.0 | 0.0 | 0.0 |
| LT borrowings | | (0.8) | (0.8) | (0.8) | (0.5) |
| Other LT liabilities | | 8.6 | 0.1 | 1.6 | 0.7 |
| Dividend paid | | (0.6) | (2.3) | (2.3) | (2.9) |
| | | 10.2 | (3.0) | (1.5) | (2.7) |
| Net cash change in year | | 1.3 | (2.9) | (6.5) | (4.6) |
| Opening cash balance | | 3.0 | 6.0 | 12.5 | 17.1 |
| Closing cash balance | | 4.3 | 3.0 | 6.0 | 12.5 |



Exhibit 19.2 Power Window Assembly

Source: www.monsterauto.com.

commodity, cost factors largely dictated the degree of success of a firm in winning orders from the major auto manufacturers.

A second competitive factor was quality. Power window assemblies were not seen by the car purchaser, and thus cosmetics, fit, and finish were not an issue. However, a faulty assembly was expensive to repair and considered a serious and annoying quality flaw by car buyers. Although not a drive-train part, the power window was still a moving part and could experience relatively heavy or abusive use. Thus a reputation for building sturdy and reliable quality parts was a key aspect of winning supply bids. With an experienced and dedicated workforce, Kilgore had built an enviable reputation as a reliable supplier of quality assemblies. However, given the simplicity of the technology, this was a difficult competitive advantage on which to differentiate the company from its competitors. The technology of window assemblies had changed little in the past 10 years and was not expected to change much going forward.

A third competitive factor for Kilgore was its philosophy of “sticking to its knitting,” a favorite phrase of Steve MacLinden. Before settling on the manufacture of power windows, Kilgore had tried custom manufacturing as well as an expansion of the types of components manufactured for the OEM industry. The operational and financial results were mediocre at best. With a small management team and no special expertise in operations management, the operational and innovation demands of nonspecialization proved too challenging for Kilgore to manage successfully.

An additional argument for “sticking to its knitting” was Steve’s lack of a background in engineering or operations. By staying with the production of a commodity product that was sold on the basis of cost and reliability and not innovation or changing functionality, Kilgore did not have to concern itself as much with the ongoing maintenance of a joint venture type of relationship with its customers. Participating in the major industry trade shows and Steve’s natural inclination toward sales were generally enough contact with customers to keep Kilgore in the loop and competitive. In this way Kilgore was able to fly below the radar of the large consolidated OEM manufacturers and survive within its niche.

In terms of its own suppliers, Kilgore utilized Canadian specialty manufacturers and raw metal suppliers. This kept the company’s own supply issues simple, and allowed it to work with lower levels of inventory, which in turn

helped alleviate at least some of its cash flow problems. For heavy demand periods, many potential U.S.-based suppliers existed, but had been used only sparingly. Buying in bulk from Asian suppliers was attractive in terms of pricing, but financing such transactions was difficult and Steve preferred having strong local connections in case any issues arose. Steve was well aware of the horror stories that were common in the industry of trying to fix a problem with a foreign supplier who spoke a different language, was in a time zone that was different by 12 hours, and was at least an 18-hour plane flight away from a potential meeting. Additionally, the use of foreign suppliers complicated exchange rate transactions, which was another management hassle that historically the management team did not feel was justified or necessary. Going forward, Steve believed that Kilgore's existing suppliers would be able to fulfill the company's increased needs with the new contract.

THE MANAGEMENT TEAM

The management team at Kilgore was led by Steve MacLinden, who was now in his late fifties; his role was that of owner and chief executive officer. Although he participated in all major decisions of the company, he basically left the day-to-day operations of the company to the rest of the management team and focused on customer relationships and making sure the company kept a good profile in the industry.

Another member of the senior management team was Rory Sullivan, who was in his late sixties and was a long-term veteran of auto manufacturing. Rory had an engineering background and had worked his way up to plant manager for one of the big three auto manufacturers before joining Kilgore upon his retirement. Rory was responsible for all manufacturing and plant operations.

Casey Dobbelstyn was the youngest and also the newest member of the management team. Casey, who had a background in international heavy equipment sales, was in charge of sales and client relationships. He also managed supplier relationships.

Completing the management team was Cathy Williams, who was the treasurer and de facto chief financial officer. After graduation from university, Cathy started her career with one of the large accounting firms and quickly obtained her Chartered Accountant qualifications. However, rather than continue within the confines of a large firm, Cathy set up a small independent accounting firm with a few like-minded colleagues so she could focus on her family and maintain what she believed was a better work/life balance. When her children started in university, Cathy returned to a large accounting firm where she was involved in a number of different accounting and auditing roles. She was being considered for partnership in the accounting firm when she was approached three years ago by her B-school acquaintance Steve MacLinden to fill the vacancy of treasurer at Kilgore. Cathy was easily persuaded that life in a large firm was not for her and jumped at the chance to embark on what she considered a more challenging future and one where she could help shape strategy. Cathy had built up the treasury team from two to five persons, including herself, and had gained the respect of all team members as smart and capable. One of her major decisions as treasurer was to implement a cash management system that significantly helped to reduce, but not eliminate,

the chronic cash flow problems that plagued Kilgore. She also played a major role in Kilgore's decision to implement enterprise risk management that was a slightly modified version of ISO 31000.

THE COMPANY

Kilgore is a private company 100 percent owned by Steve MacLinden. Steve's long-term plan is to exit the business when he is ready to retire in probably five to 10 years. Steve's only child is a daughter who has gone into acting and has no desire to join the company. Therefore, Steve's view is that the company must either be sold to one of the large publicly traded OEM manufacturers or be floated as a public company as a way for him to exit the company profitably. Either way, the next few years would be pivotal in ensuring that the business is on a sound footing and increasingly profitable, and hence has an enhanced exit value. It is also in his plans, if possible, to leave a portion of the company through a share distribution to the employees who stayed with him throughout the years and who helped him keep the company a going concern.

The main focus of the company had always seemed to be cash flow management. While the business had managed to be profitable on an accounting basis over the past five years, it seemed that Kilgore was always short of cash at critical times of the year. In part this was due to thin margins and generous payment terms demanded by the auto manufacturers that were Kilgore's key clients. With tight market conditions, the major auto manufacturers were able to demand and get extended payment terms. Thus management of cash flow was a key function for Cathy Williams and her treasury team to focus on. While economic conditions in the automobile industry had improved dramatically since the depths of the 2008 financial crisis, banks were still wary of extending operational lines of credit. Many industry observers felt that the overall market conditions were still shaky and the recent increase in automobile sales and profits might be a consequence of necessary replacement of aging vehicles, rather than a sustained improvement in the mind-set of consumers, as many consumers delayed new car purchases as a result of the 2008 crisis. A chart of U.S.-based auto sales is shown in Exhibit 19.3.

The new U.S. auto supply contract held the risk of dramatically increasing the concerns about cash flow management. While the addition of accounting and control systems that Cathy and her team had implemented had improved the cash flow situation significantly, the net profit margins were still quite tight. The added uncertainty of exchange rate fluctuations might throw things out of balance, and the company would be forced to scramble on a monthly basis to make payroll as it had done previously.

THE NEW CONTRACT

The new contract would dramatically increase the existing sales of Kilgore, and if all of the embedded options were exercised, the effect on Kilgore could be an additional increase in sales over the next five years of more than 100 percent. In terms of the potential for enhancing the valuation of Kilgore, and Steve's considering liquidating at least some of his sole ownership in the company in 5 to 10 years, the timing of the deal could not be better.

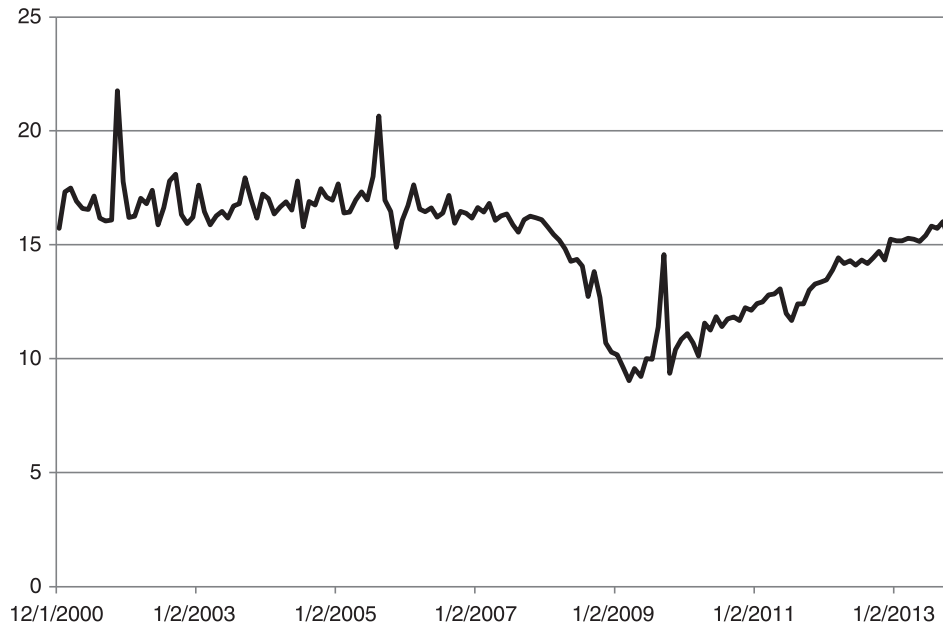


Exhibit 19.3 U.S. Monthly Auto Sales, Million of Units

Source: Bloomberg LLC.

While the technical specifications of the contract seemed highly complex and exacting, they basically laid out the design specifications for power window assemblies that Kilgore had extensive experience in producing. Some of the more complex parts of the contract dealt with unexpected, but potential, implications of significant design and production changes. In essence the contract had provisions that compensated Kilgore for any necessary modifications in the technical details of what would be produced. Thus, in terms of operational risk, it was felt that the contract was of low risk to Kilgore. While changes would have to be made to manufacturing processes and capacity, it was expected that these would proceed relatively smoothly given Rory's experience.

The more troubling aspects of the contract were financial, and more specifically the need to manage the financial risk. Under the terms of the contract, all proceeds to Kilgore were to be in U.S. dollars, even though virtually all of Kilgore's expenses were in Canadian dollars. The Japanese car manufacturer was setting up a plant to supply the U.S. market and in turn demanded that all supply contracts also be denominated in U.S. dollars. Part of the reason for doing so was to mitigate its own potential cyclical profitability due to exchange rate cycles. A second reason was the need for geographic diversity. The 2011 earthquake and tsunami in Japan had exposed a weakness of basing too much of a company's supply chain within a single region. While it wanted to diversify its supply chain across North America and utilize not only U.S. but also Mexican and Canadian suppliers, it did not want to incur currency risk.



Exhibit 19.4 USD/CAD Exchange Rate

Source: Bloomberg LLC.

Additionally, the contract had several built-in options whose exercise would benefit the Japanese manufacturer. For example, the contract could be extended by an additional three years. While there were provisions for payment of development expenses of retooling for any unforeseen model changes, the base profit margin in U.S. dollars was fixed. A second option embedded in the contract would allow the Japanese manufacturer to increase the number of units bought per year by up to 50 percent at the same fixed price. If the full range of options were exercised, this one supply contract would comprise almost 60 percent of Kilgore's total sales.

A major concern of Cathy Williams was the potential profitability of the contract, particularly when the embedded options were considered. With current U.S./Canadian dollar exchange rates, the contract was relatively profitable for Kilgore. Cathy calculated that there was approximately an 8 percent net profit margin built into the contract, which was only slightly below industry standards. The lower profit margin was considered to be a trade-off for the longer-term stability of the contract. However, a shift to a stronger Canadian dollar could quickly eliminate any profitability and potentially even lock Kilgore into a long-term loss. A chart of the history of the USD/CAD exchange rate is shown in Exhibit 19.4. Of particular concern was the potential for the Canadian dollar to creep above par as it had done periodically over the past five years.

A second concern was the potential for any inflation differentials between Canada and the United States. The contract had a built-in quarterly pricing adjustment based on the U.S. Producer Price Index (PPI). Kilgore's manufacturing costs, however, were more closely linked to the Canadian PPI, particularly as Kilgore's

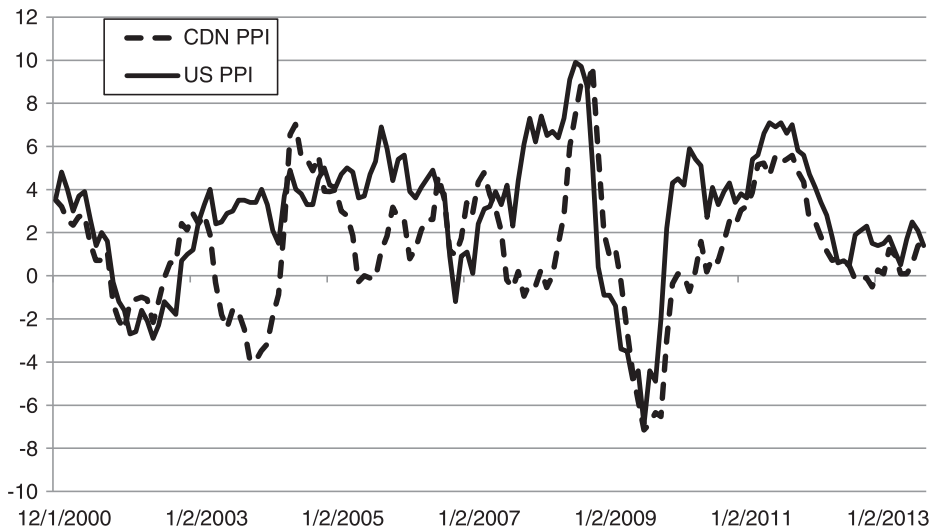


Exhibit 19.5 U.S. and Canadian Producer Price Indexes

Source: Bloomberg LLC.

union contract was linked to Canadian PPI, as were the union contracts of most of its own suppliers. While the U.S. PPI and the Canadian PPI were closely linked, the relationship was not perfect. Political events on either side of the border could potentially change the economics of the deal for Kilgore. The respective PPIs for the United States and for Canada are shown in Exhibit 19.5.

If the full range of embedded options were exercised, and if exchange rates or inflation differentials moved adversely, the contract could potentially lock Kilgore into a long-term loss and essentially scuttle any plans to take the company public or to sell it as a going concern. Conversely, if the profitability of the contract could be maintained, it had the potential to significantly alter the profitability of Kilgore and give it the scope and economy of scale necessary to seek out other opportunities and to provide Steve MacLinden with a very attractive valuation for his company.

THE FINANCIAL RISK MANAGEMENT MEETING

To deal with the financial risk arising from the new contract, Cathy and her team had been discussing the issues and ideas for managing them with Steve since the start of negotiations with the Japanese manufacturer. Everyone recognized the central importance of getting the risk management strategy right, even if the nuanced details of how to hedge created a series of quandaries. That led to Steve bringing in Rory and Casey to apply a fresh perspective to the problem. However, they proved to be of limited help, and Cathy thought they made the discussion regress with their questions about how the various hedging products worked.

Up until now, Kilgore did not have to concern itself much with currency hedging. With sales and expenses almost exclusively in Canadian dollars, there was little need for it. Likewise, the low Canadian dollar from the mid-1990s through 2004

had meant that the threat of U.S.-based suppliers entering the Canadian OEM market was minimal. That all changed of course with the new contract and with the Canadian dollar close to par with the U.S. dollar.

Cathy and her team had been discussing the various issues and how best to handle them for a couple of weeks, but in the process they were generating more questions than answers. That had precipitated the meeting with the management team that had begun two hours before. Steve was a little lost, and frankly intimidated by the choices that Cathy and her team had put forward. While conceptually Steve understood options, forwards, and swaps, the details and the implications of using the different contracts were confusing to him. Deep down he liked making things and selling things, and preferred to leave the finer financial details to others.

Casey, the sales manager, for the most part stayed out of the discussion. He felt that currency risk was something that was beyond both his control and his area of expertise. However, he did appreciate how a sound hedging strategy could give him an edge in negotiating new sales contracts with other foreign customers.

Rory, however, pounced on the opportunity to give his opinion about a hedging strategy. He liked the certainty of cost projections and believed that entering into long-term swap contracts would be best. He particularly favored doing a currency swap, which would allow Kilgore to fix the exchange rate at which it would exchange a set amount of U.S. dollars for Canadian dollars throughout the period of the contract. Cathy, however, was concerned that it could lock them in too much and potentially eliminate the opportunity for bigger upside profits. Casey at this point wondered aloud if it was possible to just hedge 50 percent of the size of the contract: "That way we will be right on at least half of the hedge." Cathy just glared at him for that comment, and thus Casey remained quiet thereafter.

There was also the issue of how to structure a swap to account for the embedded options in the manufacturing contract. If the options in the manufacturing contract were exercised by the customer, a standard swap could leave Kilgore exposed at unfavorable rates. Conversely, if Kilgore entered into swaps expecting the contract options to be exercised and they weren't, then it exposed Kilgore to being overhedged.

While he didn't fully appreciate all the nuances, Steve did recognize that they could be at a significant disadvantage on new contracts to U.S. competitors (and even Asian competitors) if the Canadian dollar appreciated in the long term and they were locked into a long-term currency swap agreement. This could dramatically affect the value of any exit strategy he might choose.

Cathy explained that an alternative to a swap would be to use short-term forward contracts. These would have to be rolled over on a frequent basis due to their shorter term; however, they would provide more flexibility and would not lock in Kilgore for more than a year, or even less if shorter-term contracts were utilized. However, this created a new form of uncertainty as rates on forwards several years into the contract would be unknown, and thus Kilgore could be locking in at either more advantageous or more disadvantageous rates in future hedges. There was also the concern that doing forwards or swaps would use up Kilgore's borrowing capacity at the bank. Having financial flexibility and borrowing capacity would be crucial until Kilgore got a handle on the cash flow implications. For this reason Cathy and her team explored the use of currency futures contracts. While these contracts had the advantage of being exchange traded, the maintenance of margin

requirements would be another issue for Cathy's team to manage, to say nothing of the potential short-term implications of margin calls on cash flow concerns.

A third alternative was to use currency options. The advantage of options is that they would provide the most flexibility and would permit Kilgore to have windfall gains from advantageous movements in the Canadian dollar. This advantage, however, was offset by the fact that options incur an up-front cost—a cost that Rory argued would eat into the profitability of the contract. Belinda, a member of Cathy's team, had made some initial inquiries with Kilgore's bankers and calculated that the cost of three-month currency put options on the U.S. dollar would be approximately 1.3 percent of the notional amount of the contract.

A host of other issues remained to be examined as well. There were several operational issues such as who would be responsible for managing the hedges and choosing counterparties. There was also an issue of how any financial risk would be accounted for in the company's slowly developing commitment to an enterprise risk management framework.

It was near the end of the meeting when Steve asked if it was reasonable to not hedge at all and just "hope for the best." "After all," he added, "if things work out as they have been going, the contract should be quite profitable as it is. Why mess with something until it is broken?" That comment led to Cathy emphatically stating that "Hope is not a risk strategy!"

Therefore, there was a multitude of issues. The main concerns from Cathy's point of view were: (1) what products should be used to hedge the exchange rate risk, (2) whether the company should hedge the full exposure, (3) who should make the hedging decisions and take ultimate responsibility for them, (4) whether the company should use exchange-traded products or over-the-counter bank products, (5) how they should take into account the embedded options in the contract, and (6) how they should assess the effectiveness of the hedging that they were doing—what reports would they need to produce, and how would the analysis fit into an ERM framework? Cathy suspected that there were other issues, but these seemed to be the main issues that the discussions seemed to be coming back to.

Leaving the meeting, Cathy knew there were more loose ends than solutions. She needed to build a financial risk management process that was effective, easy to operate, and easy for everyone to understand. It also had to see the company through to the conclusion of the contract and any other long-term plans that Steve had for the company, and for himself. There was a lot riding on this, both for the company and for her career.

QUESTIONS

1. Assume that the management team has hired you to advise them on their overall risk profile and has asked you to prepare a SWOT analysis for their review and as input to the upcoming strategic planning session. What would you put into your analysis? Additionally, how does your analysis affect the risk management strategies that Kilgore might choose to utilize?
2. What are the main financial risk management issues that Cathy and the rest of the management team at Kilgore need to focus on?
3. What kind of a financial risk management strategy would you create to solve those issues?

4. What are the major opportunities and downside risks with the hedging framework that you suggest?
5. Besides hedging the Japanese manufacturer contract, how else might Kilgore effectively use financial risk management?
6. What factors need to be considered when integrating financial risk management into an enterprise risk management framework?

ABOUT THE CONTRIBUTORS

Rick Nason, PhD, CFA, has an extensive background in the capital markets and derivatives industry, having worked in equity derivatives and exotics, credit derivatives, and capital markets training in a senior capacity at several different global financial institutions. Rick is a founding partner of RSD Solutions, a risk management consultancy that specializes in financial risk management consulting and training for corporations, investment funds, and banks. Dr. Nason is also an Associate Professor of Finance at Dalhousie University in Halifax, Nova Scotia, where he teaches graduate classes in corporate finance, investments, enterprise risk management, and derivatives. He has been awarded several teaching awards as well as being selected MBA Professor of the Year several times. His research interests are in financial risk management, enterprise risk management, and complexity.

Rick has an MSc in physics from the University of Pittsburgh and an MBA and a PhD in finance from the Richard Ivey Business School at the University of Western Ontario. Additionally, he is a Chartered Financial Analyst charterholder. In his spare time he enjoys practicing risk management principles as he plays with his collection of pinball machines.

Stephen McPhie, CA, in his current position as partner of RSD Solutions Inc., advises businesses internationally on various aspects of financial strategy and risk mitigation. From 2000 to 2004, Stephen worked in London for Italy's largest bank. In the financial engineering group, he successfully created innovative cross-border financing structures that included private equity instruments with embedded derivatives. Previously he structured and distributed primary market debt and traded distressed and near-par debt in secondary markets.

Prior to 2000, Stephen held various positions in the United States, Canada, and the United Kingdom with a "big five" Canadian bank. His experience stretches from structuring and distributing leveraged and investment grade corporate transactions to relationship management, par and distressed secondary market trading, structured credit derivative products, workouts and credit and financial mandates, structuring and negotiating transactions (including leveraged, project finance, recapitalization of distressed situations, etc.), as well as negotiating complex legal documentation.

Stephen holds a BA in economics from Heriot-Watt University in Edinburgh, Scotland, and has qualified as a Chartered Accountant in both the United Kingdom and Canada. In this respect he worked for one of the large accounting firms carrying out assignments in the fields of audit, consultancy (including business valuations), and taxation.

