Chapter 8: Strategy Formulation

From the situation analysis, two fundamental areas need to be focus by the Cacao International Sdn. Bhd. in order to gain sustainable competitive advantage.

First: The availability of the raw material at the right price, right time and right quality at the right place determines the competitive advantages. Due to the scarcity of raw material in Malaysia, the company needs to continuously search for new raw material and further improve the plant efficient to achieve higher economies of scale. Customization and technical support will be the core competencies needed to sustain through creating barriers by measures of perceptions of uniqueness and raising buyer's performances. Thus the company shall have cost advantages, differentiation and focus in the niche market in order to sustain in the global economy. The complete strategy to adopt by the company shall be a balanced mix of all the generic business level strategy by Michael Porter, 1985.

Second: The procurement and the purchasing of coca bean are of prime importance. The ability of the management to manage interest risk as well as price risk will determine the profitability of the firm.

8.1 Price Risk Management

Price risk management is the approach, which attempts to limit the potential of an economic loss as the result of a change in commodity price. It also deals in the exchange of risk. For example, the prospect of stable costs insured by locking in the forward commodity cost may result in loss of competitive advantage if the price subsequently falls and competitors hold relatively less cover.

The commodity futures industry plays an integral role in helping businesses to manage risk. The primary role of the commodity futures industry is to provide he economic function of price discovery and price risk management. Hedging, in its simplest form, is the practice of offsetting the price risk inherent in any cash market position by taking an equal but opposite position in the futures market. Hedger uses the futures market to protect their businesses from adverse price changes that could negatively impact the bottom-line profitability of their businesses

The establishment of the price risk management program has several importance. The most important of all is the establishment of a clearly defined policy objectives and coverage limits. In the Cacao International Sdn. Bhd., the management team has set 3000 open interests as the maximum allowable limit. Forecast prices using market fundamentals, accounting for speculative flow and government policy is required for price risk management.

Short term and intermediate changes in the cocoa price are a function of:
a) Crop size, which is function of weather and disease control
b) Foreign exchange rate movement
c) Speculative demand

The majority of the world is subject to free trade in the form of beans or products imported by consuming countries from the origin producers. Therefore the relative strength of the import currency represents the true cost to the importers. Weakening of the German mark resulting in a significant price increase to the continental European buyer. The same scenario happened in Malaysia as devaluation of the Ringgit resulting in high cost of importing cocoa bean.

Currency exchange rate fluctuation is also a prime factor in the control of raw material price. As the company imports 50 % of the cocoa bean, depreciation of

Table 6: Sensitivity Analysis

LIFFE	Differential	Ex. Rate	Butter Ratio	Net turnover	Bean Cost	Other Cost	Total Cost	Net Profit	Profit %
800	105	5.43	2.3	155874	120768	31310	152078	3796	2.44
850	105	5.43	2.3	165349	129440	31310	160750	4599	2.78
900	105	5.43	2.3	174850	138144	31310	169454	5396	3.09
950	105	5.43	2.3	184361	146816	31310	178126	6235	3.38
1000	105	5.43	2.3	193862	155520	31310	186830	7032	3.63

Differential	LIFFE	Ex. Rate	Butter Ratio	Net turnover	Bean Cost	Other Cost	Total Cost	Net Profit	Profit %
100	900	5.43	2.3	174850	139008	31310	170318	4532	2.59
105	900	5.43	2.3	174850	138144	31310	169454	5396	3.09
110	900	5.43	2.3	174850	137280	31310	168590	6260	3.58
115	900	5.43	2.3	174850	136416	31310	167726	7124	4.07
120	900	5.43	2.3	174850	135520	31310	166830	8020	4.59

Ex. Rate	LIFFE	Differential	Butter Ratio	Net turnover	Bean Cost	Other Cost	Total Cost	Net Profit	Profit %
5.3	900	105	2.3	170716	134848	31310	166158	4558	2.67
5.4	900	105	2.3	174850	138144	31310	169454	5396	3.09
5.5	900	105	2.3	177067	139936	31310	171246	5821	3.29
5.6	900	105	2.3	180257	142464	31310	173774	6483	3.60
5.8	900	105	2.3	186610	147552	31310	178862	7748	4.15
6	900	105	2.3	192759	152640	31310	183950	8809	4.57

Butter Ratio	LIFFE	Ex. Rate	Diffe+D10rer	Net turnover	Bean Cost	Other Cost	Total Cost	Net Profit	Profit %
2.3	900	5.43	105	172571	138144	31310	169454	3117	1.81
2.3	900	5.43	105	174850	138144	31310	169454	5396	3.09
2.3	900	5.43	105	177129	138144	31310	169454	7675	4.33
2.3	900	5.43	105	179417	138144	31310	169454	9963	5.55

Table 7: Exchange Rate of Malaysia Ringgit

Peroid	RM per unit of (average for priod)	
	USD	Sterling pound
1997	2.7902	4.5802
Jan	2.4734	4.1196
Feb	2.4682	4.0151
Mar	2.4584	3.9581
Apr	2.4817	4.0481
May	2.4853	4.0606
Jun	2.4971	4.1091
Jul	2.5539	4.2421
Aug	2.7113	4.3491
Sep	2.9949	4.7905
Oct	3.2598	5.3257
Nov	3.3524	5.6658
Dec	3.7457	6.2483
1998	3.8862	6.4529
Jan	4.3833	7.2205
Feb	3.7387	6.1612
Mar	3.6613	6.1137
Apr	3.6789	6.1572
May	3.7618	6.1755
Jun	3.9276	6.4902
Jul	4.1124	6.765
Aug	4.1568	6.7795
Sep	3.7588	6.3805
Oct	3.8183	6.4674
Nov	3.8183	6.3441
Dec	3.8183	6.3796
1999	3.8183	6.1899
Jan	3.8183	6.3011
Feb	3.8183	6.2217
Mar	3.8183	6.1922
Apr	3.8183	6.1489
May	3.8183	6.1701
Jun	3.8183	6.1052

(source: Reuters)

the Ringgit will result in more Ringgit required in exchange for one metric tonne of cocoa bean. This increases the contribution factor to the cost structure.

8.2 Effect of the price, exchange rate and the cocoa butter price

From table 6, Sensitivity analysis is performed. One variable is tested while others variable is holding constant. Price increase from 800 sterling pound to 1000 sterling pounds will increase the profit from 2.44 percent to 3.63 percent. or approximately 2millions ringgit in profit. Narrowing of the cocoa price differential from 120 to 100 sterling pounds caused the profit decline by 2 percent. Widening of the exchange rate will increase the profit as the company's profit is measured in Ringgit. Cocoa butter price movement as well will affect the profitability of the company. From the analysis, bean price, exchange rate and cocoa butter price is the determinant of the company profit. The ability to manage these factors will ensure profitability and competitiveness of the firm. Table 7 showed that exchange rate of USD against ringgit Malaysia is pegged at 3.8 ringgit, but sterling pounds are fluctuated. The ability of the company manages the exchange risk appropriate strategy will minimize losses in exchange rate.

8.3 Hedging Strategy

As a commodity processing company, the profit shall generate from the operating activities. Thus back-to-back covering strategy shall adopt to manage the price risk.

8.3.1 *Hedging the price risk*
(Assume no transaction cost involved)

In September 1999, purchase cocoa bean at 686 sterling pound for 3000 mt of cocoa. Immediately sold same amount of bean in future market, 300 lots at 716

sterling pounds for December terminal.

In December 1999, received 3000 metric tones of cocoa and pay supplier at 686 sterling pounds. Spot cocoa bean price has decline to 630 sterling pound. Buy back future at 650 sterling pounds.

The profit :
loss in the actual purchase = 3000* (686-630) =16,800
Profit from the future market= 3000* (716-650) = 19,800

Thus hedging profit of 3000 sterling pounds achieved. Without hedging, the loss in the physical purchase will amount to 16,800 Sterling pounds.

8.3.2 *Hedging of the finished products*

In November 1999, Cacao International hold an inventory of finished goods amounting to the 1000 mt raw material at total revenue 1.05 factor of the bean price at spot price of 666 Sterling pounds unsold. To hedge the price reduction, the trading manager decided sell to future at 686 sterling pounds at 105 contacts in cocoa future market.

In December, the stock was sold to a trading house at 630 sterling pounds times the ratio point. The trading manager close off the position by sell the future contract in the future market at 650 sterling pounds.

The profit from hedging = 105*10* (686-650) =37,800

The losses in the physical = 1000*(666-630)= 36,000

Although hedging can minimize risk, however it's depended on the pricing as well

as well the payment term and it's subject to currency risk. When customer purchase by an out-right price, the nearly perfect hedging is impossible to practice through coca bean future market.

8.3.3 *Hedging of the currency risk*

In September 1996, from the sales proceed, expecting customers pay 10 millions sterling pounds December,1999. Financial manager sold the pounds in the currency market through Repco at the future price equivalent to 6.3 ringgit per sterling pounds. The numbers of future contract sold was 160 contracts at 1.66.

In December 1999, Cacao International received 10 millions sterling pounds and the exchange rate at cable rate of 1.600 and the future price is 1.610. The currency exchange of Malaysia ringgit was 6.08 per pound sterling.

the profit from the hedging is 160*62500*0.05=500,000 pounds.

=3.04 millions ringgit

the loss in exchange = 10 millions* (0.22)=2.2 millions ringgit.

Under volatile currency market, changes in exchange expose company to greater risk and lower the profitability. Under unhedge position, the opportunities lost was 2.2 million. However, through proper hedging strategy, 0.84 million can be captured by the company.

Malaysia will reduce the availability of raw material and increase the inventory cost in the future. The ability of the company to purchase the right type of cocoa bean at the right price and at the right time will determine the availability of raw material.

Indonesia, the worlds' third largest cocoa producer will be the substitution of Malaysia source. The capability of the company to foster partnerships with the local cocoa bean collectors might be the only solution to ensure enough raw materials for sustainability. Policy on the price risk management needs to be established. Appropriate hedging strategy such as back to back hedging strategy is needed in order to protect the business from sudden price movements. Planning for raw material, hedging position and physical raw material availability are required and constantly need to be revised according to the market scenario. The problems faced by the trading manager will be solved if the understanding of