VOYAGES SOLEIL: THE HEDGING DECISION

On March 30, 2002, Jacques Dupuis, president and owner of Voyages Soleil (VS), one of Quebec’s leading tour operators in packaged vacations to the Caribbean and South America, sat at his desk in downtown Montreal, pondering what measures he should take to manage his company’s upcoming foreign exchange obligations.

On April 1, 2002, Dupuis and his management team must finalize their contracts for hotel rooms for the upcoming fall and winter seasons. Even though the contracts were finalized on April 1, the actual payments were not due until the beginning of the winter season (October 1, 2002). As a consequence, Dupuis needed to determine how to deal with the foreign exchange risk on the US$60 million in payables for this fall, based on the tour company’s expected volume for the coming season.

Industry

Between 1998 and September 11, 2001 (9/11), the Canadian tour operating industry had been flourishing, showing average growth rates above eight per cent. The strength of the Canadian economy was bolstering sales as this industry was very positively correlated with the overall economy (see Exhibit 1). After the terrorist attacks of 9/11 in the United States, the overall economy slowed down somewhat, but the travel industry, which comprises of airlines, hotels, cruise lines, etc., was hit much harder. Specifically, any form of tourism involving air travel
was severely affected. Increased security, increased delays at airports and fear of air travel persisted.

Following the events of 9/11, the total number of trips Canadians made to the United States dropped by almost 25 per cent. Although the majority of this drop was believed to be a result of factors related to terrorism, the falling value of the Canadian dollar had been slowing travel to the United States before 9/11. Though VS had seen only a slight decline in business during the winter of 2001-2002, overall trips by Canadians to Florida had fallen by 15 per cent and those to Mexico by 12 per cent in this period.

The decline in business following the events of 9/11 had resulted in two of Quebec’s seven tour operators declaring bankruptcy, and the rest were struggling to ensure their survival. Indeed, the volumes for the tour operating industry in Quebec declined by between 30 per cent and 50 per cent. It was mainly the smaller, less well-known firms that had been unable to weather this storm. As a result, the industry climate became one of stringent competition, to service the few who were willing to travel, and risk minimization with regards to product lines and capital expansion. Due to these conditions, all five remaining tour operators were projecting negative earnings for 2002 but were hoping that conditions would improve in the next year, as concerns revolving around the events from 9/11 and the changing nature of air travel started to subside.

**Voyages Soleil, Inc.**

VS had serviced Quebec travellers since 1975. Since that time, it had established itself as one of Quebec’s leading tour operators. The company built strong relationships with its customers over this time, and it became a trusted client of the airlines and hoteliers in its southern markets. VS’s strong reputation among customers and suppliers and its leadership position in the market had allowed VS to experience sales growth of roughly 50 per cent from 1997 to 2001. Since 9/11, VS had, however, seen a decline of roughly five per cent, which was much less than experienced by its competitors.

VS provided a wide range of products to its clients. During the winter months, VS offered travel packages that included air travel and a resort stay at the destination of the client’s choice. Possible destinations available to VS’s clients included: the French Caribbean (Guadeloupe and Martinique), Costa Rica, Cuba, Dominican Republic, Florida, Mexico, Nicaragua and Venezuela. Over the upcoming 2002/2003 winter season, VS had reserved a slightly larger number of rooms than it had reserved last year in over 35 hotels in all eight destinations, with a bill totalling US$60 million. Although VS had some leftover rooms in the previous year, Dupuis was forecasting a return to the pre-9/11 levels for the upcoming season and therefore did not want to be left short.
Since the majority of VS’s clients were from Quebec, the clients paid for these packages in Canadian dollars, but the hotels at these destinations would accept payment in U.S. dollars only. As a consequence, VS faced foreign exchange risk on its packages. Further complicating this situation, VS had to book its space with these resorts in April and pay for them by October of the same year, and it had to determine the prices to charge its clients in April so that the brochures could be printed and ready for its clients to start booking their travel in September. Though clients could start booking their packages as early as September, the majority booked and paid for their packages in October and November. When economic conditions were challenging, clients would wait until December or January to book.

As a consequence of this arrangement, one of the major concerns facing VS was the impact that changes in the Canadian dollar may have on the company’s ability to pay its suppliers in October. Exhibit 2 demonstrates how the Canadian dollar has been decreasing in value over the past decade. In particular, since 1998, the Canadian dollar has gone from 0.6940 US$/Cdn$ in January 1998 to 0.6298 US$/Cdn$ in March 2002, having hit historical lows in February 2002. Because of the low value of the Canadian dollar and the crippling aftermath of 9/11 on the travel industry, Dupuis had to decide what to do with his U.S.-dollar obligations for hotels in the coming year. At the current exchange rate of 0.6298 US$/Cdn$, the US$60 million payable would cost over Cdn$95 million. If the Canadian dollar were to continue depreciating and reach 0.6000 US$/Cdn$, for instance,1 the payable would then be Cdn$100 million. Due to the competitive market, VS needed to price its products aggressively to attract customers yet still provide enough of a mark-up to protect itself from adverse movements in the exchange rates. This had always been an issue for VS, and Dupuis had tended to be risk averse in the face of these uncertainties.

Economic Climate

Since 1998, the S&P/TSX Composite Index for the Canadian equities market has continued to fluctuate and has only recently stabilized following the impact of the events of 9/11 (Exhibit 3). After peaking in July 2001, the Index had decreased in value. The events of 9/11 only strengthened the losses. By the end of 2001, however, the value of the Index appeared to be stabilizing. Despite the slowing of the growth in the equity markets since the early 1990s, Canadian GDP growth remained positive (Exhibit 1). In March of 2002, the growth in GDP was reported to be a positive 2.4 per cent annualized, and expectations for the coming months were for continued positive growth at above three per cent. Interest rates in both Canada and the United States were expected to continue their decreasing trend in

1 In a CIBC World Markets report in October 2000, Jeffrey Rubin writes that while “the timing may be a little premature.” He predicted that the Canadian dollar would be heading for 60 cents within the next 12 to 18 months.
an attempt to stimulate the economy after the fall in consumer confidence post-9/11 (see Exhibit 4).

There were several factors affecting the fluctuations in the value of the U.S. dollar. In the short term, a slower-than-expected recovery of the financial markets and high-profile corporate scandals had hurt the U.S. dollar, but these conditions were not expected to persist. In the long term, it was frequently believed that the U.S. dollar would be negatively affected by concerns over the large and growing current account deficit. However, the widening gap of the current account deficit was expected to be offset by productivity increases, the U.S. dollar was expected to remain at its current levels.

Since the Canadian dollar continued to fall in the wake of the events of 9/11 despite the strong Canadian economy, analysts were unclear about the future direction of the Canadian dollar. The standard factors used to help forecast exchange rates were pointing in different directions (see Exhibits 4, 5, 6 and 7). These factors combined with the continuing slide of the Canadian dollar over the previous five years left Dupuis concerned that the Canadian dollar would continue to decline, hurting VS’s profitability even more. As a consequence, Dupuis did not know whether he should hedge his US$60 million payable or wait to see how the value of the Canadian dollar changed between the present time and October 2002, when VS was stipulated, by contract, to pay its hotels for the entire winter season.

**Alternatives available to Voyages Soleil**

Should the value of the U.S. dollar continue to rise versus the Canadian dollar, the hotel costs would increase significantly, hurting the already diminished margins being faced by VS due to the increasing level of competition in the Canadian travel market. In contrast, should the value of the US$ begin to decline versus the Canadian dollar, VS would be able to decrease the costs of hotels to its clients or increase margins. There were three alternatives being considered by Dupuis to cope with these risks:

1. Wait and exchange the Canadian dollars in October at the prevailing spot exchange rate at that time.
2. Employ forward contracts for all of the payable, locking in the Canadian dollar price
   - The six-month forward rate at April 1, 2002, for contracts buying up to US$100 million was 0.6271 US$/Cdn$.
3. Borrow Canadian dollars to buy U.S. dollars on April 1, 2002, and invest the U.S. dollars for six months. The loan could then be paid using the Canadian dollars available for the hotel payments.
   - In late March 2002, the spot exchange rate was 0.6298 US$/Cdn$. The Euro-Canadian dollar six-month interest rate for borrowing was 2.70 per
cent and depositing was 2.55, while the Euro-U.S. dollar (frequently just called the Eurodollar) six-month interest rate for borrowing was 1.85 per cent and depositing was 1.65 (Note: all of these rates are quoted on an annualized basis).

DECISION

VS’s situation was a precarious one. After the events of 9/11, all travel businesses, including VS, were scrounging for profit. Dupuis knew that a bad bet on foreign exchange risk could have a detrimental effect on VS’s short-term profitability. However, he knew that any profit made by the company’s foreign exchange obligations could be passed onto customers by lowering prices and essentially, swaying the undecided customer to take advantage of lower prices and raise much-needed total volume. This dilemma was further complicated by the uncertainty regarding the future demand for the proposed packages.
Exhibit 1
GROWTH RATE IN THE CANADIAN AND U.S. ECONOMIES
1990 to 2002

Source: Datastream.

Exhibit 2
U.S. DOLLAR — CANADIAN DOLLAR EXCHANGE RATE FROM 1990 TO 2002

Source: Datastream.
Exhibit 3

CANADIAN STOCK MARKET INDEX — TSE
1990 to 2002

Source: Datastream.

Exhibit 4

U.S. AND CANADIAN SIX-MONTH INTEREST RATES
1995 to 2002

Source: Datastream.
Exhibit 5

U.S. DOLLAR — CANADIAN DOLLAR SIX-MONTH FORWARD RATES
1990 to 2002

Source: Datastream.

Exhibit 6

U.S. AND CANADIAN INFLATION RATES

Source: Datastream.
Exhibit 7
US$ — CDN$ PPP EXCHANGE RATES

Source: Datastream.