

CLOSING CASE

Embraer and the Wild Ride of the Brazilian Real

For many years Brazil was a country battered by persistently high inflation. As a result the value of its currency, the real, depreciated steadily against the U.S. dollar. This changed in the early 2000s when the Brazilian government was successful in bringing down annual inflation rates into the single digits. Lower inflation, coupled with policies that paved the way for the expansion of the Brazilian economy, resulted in a steady appreciation of the real against the U.S. dollar. In May 2004, 1 real bought \$0.3121; by August 2008, 1 real bought \$0.65, an appreciation of more than 100 percent.

The appreciation of the real against the dollar was a mixed bag for Embraer, the world's largest manufacturer of regional jets of up to 110 seats and one of Brazil's most prominent industrial companies. Embraer purchases many of the parts that go into its jets, including the engines and electronics, from U.S. manufacturers. As the real appreciated against the dollar, these parts cost less when translated into reals, which benefited Embraer's

profit margins. However, the company also prices its aircraft in U.S. dollars, as do all manufacturers in the global market for commercial jet aircraft. So, as the real appreciated against the dollar, Embraer's dollar revenues were compressed when exchanged back into reals.

To try and deal with the impact of currency appreciation on its revenues, in the mid-2000s Embraer started to hedge against future appreciation of the real by buying forward contracts (forward contracts give the holder the right to exchange one currency—in this case dollars—for another—in this case reals—at some point in the future at a predetermined exchange rate). If the real had continued to appreciate, this would have been a great strategy for Embraer because the company could have locked in the rate at which sales made in dollars were exchanged back into reals. Unfortunately for Embraer, as the global financial crisis unfolded in 2008, investors fled to the dollar, which they viewed as a safe haven, and the real *depreciated* against the dollar. Between August 2008 and



November 2008, the value of the real fell by almost 40 percent against the dollar. But for the hedging, this depreciation would have actually increased Embraer's revenues in reals. Embraer, however, had locked itself into a much higher real/dollar exchange rate, and the company was forced to take a \$121 million loss on what was essentially a bad currency bet.

Since the shock of 2008, Embraer has cut back on currency hedging, and most of its dollar sales and purchases are not hedged. This makes Embraer's sales revenues very sensitive to the real/dollar exchange rate. By 2010, the Brazilian real was once more appreciating against the U.S. dollar, which pressured Embraer's revenues. By 2012, however, the Brazilian economy was stagnating, while inflation was starting to increase again. This led to a sustained fall in the value of the real, which fell from 1 real = \$0.644 in July 2011 to 1 real = \$0.40 by January 2014, a depreciation of 38 percent. What was bad for the Brazilian currency, however, was good for Embraer, whose stock price surged to the highest price since February 2008 on speculation that the decline on the real would lead to a boost in Embraer's revenues when expressed in reals.

Sources: D. Godoy, "Embraer Rallies as Brazilian Currency Weakens," *Bloomberg*, May 31, 2013; K. Kroll, "Embraer Fourth Quarter Profits Plunge 44% on Currency Woes," *Cleveland.com*, March 27, 2009; "A Fall from Grace: Brazil's Mediocre Economy," *The Economist*,

June 8, 2013; "Brazil's Economy: The Deterioration," *The Economist*, December 7, 2013.

Case Discussion Questions

- ~~1. What does the recent economic history of Brazil tell you about the relationship between price inflation and exchange rates? What other factors might determine exchange rates for the Brazilian real?~~
- ~~2. Is a decline in value of the real against the U.S. dollar good for Embraer, bad for Embraer, or a mixed bag? Explain your answer.~~
- ~~3. What kind of foreign exchange rate risks is Embraer exposed to? Can Embraer reduce these risks? How?~~
- ~~4. Do you think Embraer's decision to try and hedge against further appreciation of the real in the early 2000s was a good decision? What was the alternative?~~
- ~~5. Since 2008 Embraer has significantly reduced its dollar hedging operations. Is this wise?~~
- ~~6. Between mid-2014 and early 2015 the real depreciated significantly against the U.S. dollar. What do you think the impact was on Embraer?~~