The options of minimalization of financial risks in a travel agency

ERIK WEISS[1], ROLAND WEISS[1] and SLAVOMÍR LABANT[2]

[1] *Institute of Geotourism, Technical University of Košice, Letná 9, 042 00 Košice, Slovakia*
(e-mail: erik.weiss@tuke.sk, roland.weiss@tuke.sk)
[2] *Institute of Geodesy, Cartography and Geographic Information Systems,*
Technical University of Košice, Letná 9, 042 00 Košice, Slovakia
(e-mail: slavomir.labant@tuke.sk)

ABSTRACT
The article deals with the problem of impact of the financial risks, which for the company with so specific activity, such as travel agency , present the greatest threat.The aim of this paper is after the analysis of the selected value indicators of a particular travel agency review just precisely those risks, which is possible to minimize or ease with proper management. When obtaining the foreign capital it is important to minimize interest rate risk. We will achieve this by using financial derivative instruments specifically forward contracts on interest rate. This is among the interest derivates the most liquid instrument on the interbank market. But it is not used as much as it could be. FRA contract secures against adverse movements of interest rates by setting fixed interest rate on pre-selected period of time, not more than one year. Upon settlement it comes only to transfer the difference between the interests from the amount of basic trade calculated according to the price of FRA contract and spot reference rate – to the so-called compensation payment. This proposal is going to save 0.630 thousand Euro by drawdown in the amount of 100,000 Euro to company.

Keywords: financial risk, travel agency, minimalization

INTRODUCTION

The issue of the risk of business of travel agencies in Slovakia is very current. Nowadays the majority of them has financial and economic problems, particularly problems with lack of funds. These problems only multiply the massive arrival of strong foreign players and instantly growing threats of attractive tourist destinations by financial and economic crisis. In this article we will be dealing with minimizing of financial risk when using funds from credit products of financial institutions. This topic is highly current, since in year 2012 the famous travel agency went bankrrupt after 20 years because of financial difficulties. The travel agency was unable to pay its obligations towards its customers and suppliers. Despite these negative news the economic crisis has had just a little impact on tourist destinations in Central Europe.[1]

Worldwide in 2011, the world tourism grew by 4% according to the tourist traffic of countries. Europe has had an above-average increase of 6% as the UNWTO states. [2]

THE CHARACTERISTICS OF THE RISKS THREATENING THE BUSINESS OF TRAVEL AGENCY

Small and medium-sized companies which undoubtedly are including also the travel agencies, have some disadvantages compared to large companies. They are more intensely exposed to risks than larger companies. Drawbacks of business of small and medium-sized companies compared to big companies arise from the very nature of

small and medium-sized companies and from specific business conditions in Slovakia. Those include issues related to the organization and conduct of the business as a limited access to credit, way of guarantee of owners, small capital strength, low degree of diversification, high wedge and lengthy disputes. For companies we distinguish these types of financial risks: [3]

credit risk
- direct credit risk,
- the credit risk equivalents,
- the risk of non-payment of delivery
- risk of credit exposures,

liquidity risk
- funding risk (the risk of loss in the case of payment insolvency)
- market liquidity risk (the risk of loss in the case of low liquidity of the market with financial
- tools that limit the rapid liquidity of positions, resulting in a limited access to funds)

market risk (the risk of loss from changes of market price)
- interest rate risk,
- stock risk,
- commodity risk,
- currency risk,
- correlation risk,
- risk of credit spread,

operational risk:
- the transaction risk
- the operational risk management

- system risk

business risk:
- the legal risk
- the risk of the credit rating change
- the coveted risk
- the tax risk
- the risk of currency convertibility
- the risk of disaster
- the regulatory risk

METHODOLOGY

Expression values of risk is dependent on the method of valuation. The method used (or combined) depends on the nature of the danger and risk to persons. Overview of the appropriate methods for collecting information and data: [4]
- examiner methods
  observation methods
- statistical methods

Indebtedness of the company is most commonly expressed as a ratio of foreign capital to total capital [5].

This indicator (1.1) illustrates the structure of financial resources. While respecting the golden rule of financing, the recommended value should not exceed 50%. The value of this indicator, however, under certain circumstances, may also be accepted in the interval from 70 to 80%. Borrowing foreign funds may be considered as a cost-effective if their economic performance outweighs the problems caused by increasing volume of foreign capital.

$$\text{The total debt ratio} = \frac{\text{Total accounts payable (foreign capital)}}{\text{Total assets (total capital)}} \cdot 100 \qquad (1.1)$$

$$\text{The self-financing ratio} = \frac{\text{Equity}}{\text{Total capital}} \cdot 100 \qquad (1.2)$$

Indicator testifies about the scope of equity in relation to total resources of the company. It should not fall below 30%, exceptionally even under 20%. Sum of values of indicators The Total debt ratio and The self-financing ratio is equal to 100%.

AGREEMENT ON FUTURE INTEREST RATE (FORWARD RATE AGREEMENT - FRA)

By the agreement on forward interest rate we understand the business, in which the contracting parties agreed that in the specified date in the future they are going to pay the difference between the agreed interest from a notional principal for the agreed notional period of its maturity starting with intended date and between the interest from this notional principal for the same period of maturity starting with intended day, which will be actually offered on a intended day. [6]

Theoretical price FRA

For FRA stands:

$$F_0 = N \cdot \left(1 + r_{fra} \cdot \frac{t_{fra}}{B} \right)$$

(1.3)

and

$$F_{deal} = N \cdot \left(1 + r_{deal} \cdot \frac{t_{fra}}{B} \right)$$

(1.4)

for FRA with a maturity within one year, where

N - agreed principal
rdeal - agreed forward interest rate
RFRA - a forward interest rate on that day,
tfra - FRA period in days
B - calendar year basis in days
F0 - forward price (value) on that day of the subject of forward,

Fdeal - agreed forward price (value) of the subject of forward

or

$$F_0 = N \cdot \left(1 + R_{fra} \right)^{T_{fra}}$$

(1.5)

and

$$F_{deal} = N \cdot \left(1 + R_{deal} \right)^{T_{fra}}$$

(1.6)

for FRA with a maturity within one year and more, where
R_{deal} – agreed forward interest rate,
R_{fra} – a forward interest rate on that day,
T_{fra} – FRA period in years (can also be a fractional value: $T_{fra} = \dfrac{t_{fra}}{B}$).

Relations (1.3) and (1.4) may also be used for FRA with a maturity within one year.

The height of fulfillment is derived from: [7]
1. the difference between the agreed FRA rate and the reference rate at the decisive day,
2. the nominal value
3. the length of FRA periods.

To the term T_2 from the buyer´s view we could calculate it from the formula for calculation:

$$\frac{(p_{ref} - p_{FRA}) * t_{FRA} * NH}{360 * 100}$$

(1.7)

In practice, the implementation from the FRA applies usually at the beginning of FRA period, therefore must be discounted.

$$\frac{(p_{ref} - p_{FRA}) * t_{FRA} * NH}{36\,000 + p_{ref} * t_{FRA}}$$

(1.8)

p_{FRA} - agreed FRA rate in % p.a.
p_{ref} – the reference rate in % p.a.
t_{FRA} – length of period FRA in days
NH - nominal value FRA

ANALYSIS OF SELECTED RATIO INDICATORS OF CK TOUR COMPANY LTD.

Success or failure of the business is reflected in the financial situation of company. The goal of the analysis is to evaluate the financial situation (financial health) and precise causes that are affecting it. The aim is to express complex financial situation of the travel agency, that means to identify all the factors that determinate the financial health of the company. Within the sollution of measures to moderate the financial risks, it is necessary to know the situation of indebtedness and business activities. We selected indicators: the self-financing ratio, the debt ratio, turnover period of accounts payable and receivable, which are affected by the current interest rate on the market.

CK TOUR Ltd. collects money from its accounts receivables in a usual period for 73 days, what is quite a long period for collection of accounts receivables. Annual trend is negative. The period of collection of accountes receivables was extended slightly compared to the previous years.

Another analyzed indicator was the payment period of short-term accounts payable. In the development of this indicator since 2005, an increasing trend could be observed. In 2011 the payment of short-term acounts payable took 104 days.

The activity ratios

Tab. 1 The activity ratios

The activity ratios	Values						
	2005	2006	2007	2008	2009	2010	2011
Collection period of accounts receivables	58,257	54,538	58,258	60,542	64,656	70,822	73,097
Payment period of accounts payables	71,254	75,364	78,216	81,068	79,876	88,150	104,734

Source: internal material of travel Agency

The indebtedness ratios
SSF - self-financing ratio (the optimum value> 50%)
SZ – debt ratio (optimal value <70)
FP – financial leverage (optimum value <3)

Tab. 2 The indebtedness ratios

		2005	2006	2007	2008	2009	2010	2011
SSF	equity Total capital	0,90	0,92	0,91	0,93	0,86	0,80	0,56
SZ	Foreign capital Total capital	0,10	0,08	0,09	0,07	0,14	0,20	0,43
FP	assets equity	1,11	1,08	1,09	1,07	1,16	1,25	1,78

Source: internal material

The debt ratio expresses the ratio of resources to assets provided by the company's creditors. In parallel with the increasing proportion of assets increases the security of creditors against losses in the case of liquidation and therefore it is logical that lenders prefer a low value of this indicator. The lowest value was in 2008 and

the highest debt of the company was in 2011, which was mainly affected by the decline in profit under the influence of the current economic crisis.

PROPOSAL ON REDUCTION OF FINANCIAL RISK - GROWTH OF INTEREST RATE BY LOAN DRAWDOWN

Financing options of tourism business by help of direct credit may be from five sources: [8]
1. EBRD (European Bank for Reconstruction and Development)
2. NADSME (National Agency for Development of Small and Medium-sized companies)
3. EXIMBANKA
4. SZRB (Slovak Guarantee and Development Bank)
5. Commercial banks

Not only the mentioned travel agency but many other companies have loans in accounting, which usually have floating rate, mostly depending on the rates on the interbank market. Since there are fluctuations on the market, in advance the debtor could not be sure, what interest will be exactly valid, as it complicates the determination of feasible financial plans, so simply said he is exposed to financial risk. The aim of our proposal is to reduce the mentioned financial risk by potential of interest derivatives. Movement of interest rates will no longer have impact on the cash flow of company while using these tools.

Derivatives can be useful not only for subjects that have credit, but also for those who lent to someone else. On one hand, companies that have accounts payable in account balance, may secure against the growth of interest rate or profit from its decline. On the other hand, lenders try to maximize gain and want to limit the minimum level of interest rates, or benefit from their growth.

The most suitable interest derivative for the mentioned travel agency is so-called FRA contract (Forward Rate Agreement) - agreement on future interest rate. It is among the most liquid interest rate derivatives instruments on the interbank market. But is not used as much as it could be.

Contract FRA ensures against adverse movement of interest rates by setting fixed interest rates on pre-selected period for no longer than one year. Upon settlement it comes only to transfer of the difference between the interest from volume of the basic trade price calculated according to price of FRA contract and spot reference rate – to the so-called compensation payment. The client cannot choose the FRA rate, it must reflect the market conditions. The first number in the title expresses the number of months until the beginning of the contract and the second the date of maturity. For example, a contract FRA 6 × 9 the client closes to ensure the interest on the credit, which will he draw in six months and it will be mature in next three months, so from the actual moment in nine months.

If the debtor is afraid of rise of interests, he acts as a buyer, when the debtor of decrease, he is on the side of seller. In case of occuring of indisposed movement and the company signed a FRA contract, the bank pays the difference between scheduled and actual rate. If the interests from credit increase, the debtor pays them, but on the other hand the difference returns from FRA and vice versa. The debtor after the decrease of interest gets less, but the difference is paid back by the bank, which he signed the FRA with.

Example
The company will be requiering a six-month bridging loan of 100 000 Euro in 6 months with a interest of 6-month EURIBOR + 1%. While the company is afraid of more significant future increase in interest rates, it will buy from the bank FRA contract quoted by the bank as 2.650 to 2.770% on 100 000 Euro for 6 to 12 (the

reference rate is 6-month EURIBOR), that means the bank sells FRA by FRA-rate at 2.770% to company. This long position the company "locked down" by the interest rate at $2.770 + 1 = 3.770\%$..

Let´s suppose that the real 6-month EURIBOR for six months is 3.40%. The bank is then required due to date of payment – payoff of compensation payment occurs at the beginning of FRA period and a settlement of trade of FRA company at 0.609284 thousand Euro.

Due to date of maturity of the credit (that is 12 months) the company has to pay the amount of $100 \times (1 + 0.0340 + 0.010) = 104.4$ thousand Euro. Compensation payment due to date of maturity of the credit will have the value of $100 \times (0.0340$ to $0.0277) = 0.63$ thousand Euro (calcullated payment of 0.609284 thousand Euro is the same payment, but expressed at the beginning of the FRA period), what means that the real amount that the company will pay the bank, will be equal to 103.77 thousand Eur. This corresponds to relation of $100 \times (1 + 0.0377)$, so the resulting credit interest rate for the company is 3.770% (without FRA it would be a 4.40%).

CONCLUSION

At present it is very important for the small and medium – sized companies to minimize the risk and also the costs associated with it. By using the available financial derivatives which are normally traded on the interbank market the financial risk can be controlled. On the other hand, the decrease in interest rates could occur and by that the company could save financial tools.. But a successful business manager does not unnecessarily risk and if he has the right information and forecasts about the evolution of interest rates, he certainly approaches to FRA contract. Within reducing risks of client, the managers of travel agencies must also try to get an early detection and identification of countless amount also of so-called. external risks, that arise continuously and independently in the business unit.

REFERENCES

[1] **Zuzik, J., Vinc, L.**, Impact of economic crisis on tourism of central european countries, 2012. In: Geotourism and its implications : international PhD. conference 2012 : proceedings : Herľany, 13th-14th March 2012. - Košice : TU, 2012 S. 164-168. - ISBN 978-80-553-0902-6

[2] **UNWTO**, World tourism barometer, January 2012, www.unwto.org

[3] **Simak, L**: Manažment rizík, elektronické vydanie, Zilina, 2006

[4] **Seňová, A., Slaninová, P., Weiss, E.**: Posúdenie rizika bodovou metódou pre vybranú profesiu v ťažobnom priemysle 2008. In: Acta Montanistica Slovaca. Roč. 13, č. 2 (2008), s. 278-284. - ISSN 1335-1788

[5] **Čulková, K., Hricová, M.**, Finančno - ekonomická analýza podniku : (s aplikáciou v banskom podniku) 1. vyd - Košice : FBERG TU, - 2009. - 94 s. - ISBN 978-80-553-0261-4.

[6] Metodické usmernenie úseku bankového dohľadu č. 2/2004 k opatreniu Národnej banky Slovenska č. 4/2004 zo 16. januára 2004 o primeranosti vlastných zdrojov financovania bánk - Výpočet teoretických cien (reálnych cien) vybraných derivátov

[7] **Dvořák, P.**: Deriváty. 1. vydání. Nakladatelství Oeconomica, 2003. ISBN 80-245-0634-3

[8] **Timčák, G., Derco, J., Froncová, Ľ., Mixtaj, L., Kršák, B., Semsey, Z., Tormová, Z.**: Cestovný ruch učebný text/ G. M. Timčák ... [et al.] - [1. vyd.] - Košice : Inštitút vzdelávania veterinárnych lekárov - 2009. - 82 s. - ISBN 978-80-89280-24-7.