FOREIGN EXCHANGE BEST PRACTICES

To Hedge or Not to Hedge: Managing Foreign Exchange Risk

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>
> HARRY WINSTON DIAMOND

As the third quarter of 2007 came to a close, Canadian diamond miner and retailer Harry Winston Diamond was prepared to announce a revenue increase of 22 percent. When it came time to report earnings, however, the figure amounted to a loss and the company's stock price fell. The culprit: a sizable foreign exchange loss from the year before — to the tune of USD 7.4 million. "The strengthening of the Canadian dollar throughout the year has dramatically impacted our year-to-date net earnings and entirely masked our strong third-quarter operational results," the company said.

Unfortunately, Harry Winston Diamond is not alone. Rapid globalization has caught many otherwise healthy businesses off-guard. And most remain blissfully unaware of their exposure to foreign exchange rates until it's too late.

How do you prepare for unpredictable volatility? Clearly, avoiding overseas opportunities is not an option. For emerging, growth and established companies, as well as private equity investors, crossing national boundaries is now a prerequisite to competing in the marketplace — and that means dealing with multiple currencies whose relative values change day to day.

A proactive approach to managing foreign exchange risk protects companies against changes in international financial markets — no matter how great or small. When implemented with the guidance and support of a trusted advisor, foreign exchange hedging strategies offer a viable solution. Throughout the high-tech and life sciences industries, savvy CFOs and prudent boards are implementing these innovative financial tools to safeguard overseas cash flows and investments.

THE HEART OF THE MATTER

Foreign exchange risk affects companies in myriad ways: through overseas transactions, the conversion of one currency to another on the balance sheet, or changes in a company's competitive position in the market. Whatever the source, the consequences can be far-reaching, wiping out profits and straining relationships with partners and customers.

Consider the case of one global provider of electronic payment solutions with operations in the United States, Brazil, China, Hungary, Mexico and the United Kingdom. It reported revenues of USD 260 million in 2002 with operating income of USD 1.6 million, but experienced a material foreign exchange loss of USD 6.0 million and could not explain why.* Foreign exchange exposure turned out to be the cause. Similarly, Angiotech Pharmaceutical attributed a USD 7.8 million loss in the third quarter of 2007 to the rise in the Canadian dollar against the U.S. dollar.

> "It's not enough to hope the market moves in your favor."

Sources Of Foreign Exchange Risk

Every international transaction across national boundaries exposes either the importer or the exporter to foreign exchange risk. There are several common sources:

- Overseas sales operations
- Manufacturing facilities
- Outsourced development or support
- Customer relationships
- Supplier relationships
- Balance sheet conversions
- Changing competitive position in the economy

How will a 10 percent swing in foreign exchange rates affect your earnings? How about 100 percent?

Recall the Asian currency crisis of 1997-98, when the Korean Won lost 54 percent of its value in two months during November and December in 1997. Or reflect on the dramatic fall of the dollar against the euro in 2007. From the subprime mortgage crisis and the possibility of a U.S. recession to the strength of emerging markets, financial disruptions are making news headlines on a daily basis. With economic growth and interest rates in question, management teams need to plan for an uncertain future.

NO ZERO-SUM GAME

Yet, despite the growing case for hedging, even the most experienced CFOs often hesitate to recommend a foreign exchange strategy to their boards.

- Some believe hedging is a form of speculation.

  In the case of foreign exchange, it is not. Hedging actually reduces risk by revealing the underlying expense or revenue.

- Others believe they are immune because they price and report in dollars.

  They are not. Anytime a cross-border transaction takes place, one party inherits the foreign exchange risk.

- Still others assume that foreign exchange movements even out over time.

  They do not. The Canadian dollar is at levels last seen when Jimmy Carter was President.

It's not enough to hope the market

Is Foreign Exchange Hedging Right For Your Business?

Answer these questions to determine if your company should implement a foreign exchange hedging policy:

- Does your company generate revenue in other currencies?
- Do you need to fund an overseas office and/or subsidiaries?
- Do you have overseas suppliers, vendors, consultants or contractors?
- Do you expense costs in one currency and report associated revenue in another currency?

moves in your favor. You need to do the analysis.

The right mix of hedging products — from spot contracts and currency swaps to over-the-counter options — can minimize the probability of a business disruption by offsetting the exposure of hedged items. As the Federal Reserve Bank recently observed, "Strongly governed companies use currency derivatives more when the degree of currency exposure, expected financial distress costs and growth opportunities are higher."

MORE THAN MITIGATING RISK

When implemented responsibly, a successful foreign exchange hedging strategy can go beyond mitigating foreign exchange risk to actually improving the bottom line. For example, some companies use leading and lagging as hedging tools. Companies are able to accelerate receivables to improve their cash positions, while saving money on goods purchased abroad by postponing payments.

Leading

- Accelerate payment of strengthening currencies
- Speed up receipt of weakening currencies

Lagging

- Delay payment of weakening currencies
- Postpone receipt of strengthening currencies

Hedging a benchmark exchange rate can be a valuable tool for an overseas sales force by removing foreign exchange risk from the pricing equation and allowing the company to negotiate from a more competitive position when bidding for overseas contracts. For public companies, hedging creates shareholder value by increasing earnings predictability. Simply put, foreign exchange hedging helps companies compete more effectively in an increasingly global market.

Consider the case of one SVB client, a manufacturer of cleantech equipment that signed a contract with a supplier based in Germany. The contract was valued at EUR 22.8 million, payable over 12 months. Based on the client's foreign exchange policy, which called for the company to hedge all known foreign exchange exposures, the company entered into a series of forward contracts that extended out one year and matched its scheduled A/P payments. The euros were purchased through forward contracts and priced from 1.35-1.37.

At the end of the year, the company had met its primary objective:

> "A foreign exchange hedging strategy minimizes the probability of a business disruption by offsetting the exposure of hedged items."

the euro-denominated cash flow had a fixed U.S. dollar cost, based on the forward foreign exchange rates, and the foreign exchange risk was removed. In addition, the euro strengthened during the same time period, saving the client up to 7.5 percent based on the difference of the locked-in rate and the exchange rates on the day.

GETTING IT RIGHT

Although putting a hedging strategy in place is less complicated than many CFOs expect, there's more to it than simply calling up your neighborhood trader. A diligent company will follow these six steps to get started:

1. Collect data about your business to develop a clear picture of your foreign exchange exposure. Review transactions with overseas contractors, vendors and customers, as well as foreign currency invoices and monthly transfers.
2. Determine the ways in which foreign exchange hedging can benefit your current and future business plans.
3. Plan how you might work with a trusted foreign exchange advisor to set up a hedging strategy and monitor its risks and results.
4. Establish a foreign exchange "policies and procedures" document to formalize your strategy — and do this as you begin to expand the business, rather than after the fact.
5. Select the right financial tools for your business — and don't overlook internal hedging strategies such as matching exposure, sourcing, production and leading and lagging.

Elements of a Foreign Exchange Policy

- Objectives
- Responsibilities
- Controls
- Strategies

Foreign Exchange Hedging Products

Spot trades: These contracts are typically used for immediate delivery of foreign currency payments or converting foreign currency receipts into U.S. dollars at prevailing market rates.

Forward contracts and forward window contracts: These contracts are used to lock in exchange rates for a specific future date, or for a range of dates. Forward contracts are often used as a tool to eliminate the impact of adverse currency movements and protect profit margins by determining a forward rate for the exchange.

Currency swaps: A currency swap is a foreign exchange agreement between two parties to exchange a given amount of one currency for another, and after a specified period of time to give back the original amounts swapped. Swaps are an effective tool to manage time difference of foreign currency cash flows.

Currency options: By paying an upfront premium, over-the-counter option contracts provide the right to buy or sell a foreign currency at a predetermined rate (strike price) at a specific time frame in the future. Options are particularly useful when you need to hedge an uncertain or contingent exposure, such as one that involves tendering for a contract.

6. Work closely with your accountants, senior management and other finance team members to ensure that the strategy you select is appropriate for your company, especially because different hedging products have different cost-benefit profiles. Make sure the cost you paid for the strategy will match your company's risk-reward objective in your foreign exchange policy.

When it comes to foreign exchange hedging, choosing a financial services provider may be the most important decision you'll make. Not all banks are created equal, so it pays to do some research. Consider these criteria when evaluating potential providers:

Pre-trade advisory
Will you have direct access to experienced traders? If so, how much time do traders have to spend with clients? A personalized and consultative approach is essential to a solutions-driven strategy.

Depth of the trading floor and staffing experience
How well does your trader know your business, and does your financial services provider have a specialized focus in your industry? Does the trader have prior experience with major banks and trading the foreign exchange products that are offered?

Credit limits
How flexible is the financial services provider in its requirements?

Execution and responsiveness
Does your financial services provider trade in all liquid currencies? How easily can you get a live executable quote?

Post-trade follow-up
Will you receive your purchased currency on time? How fast will your financial services provider correct settlement problems? How easy is it to get information on transaction history and outstanding trades? Will you be able to see a mark-to-market report regularly?

Foreign exchange hedging advisory should come in the form of a bundled package of customer services addressing every step in the process, from pre-trade to execution to post-trade follow-up. By applying a deep understanding of foreign exchange markets and the forces that drive them, your financial services partner can make recommendations with your best interests in mind. A good advisor will support your existing foreign exchange strategy, help you set up a formal policy, or simply begin with a thorough review of your business to assess its exposure to foreign exchange risk.

Foreign exchange risk is a reality in today's global business environment. Accordingly, prudent boards need to plan for volatility, and responsible CFOs must bring viable foreign exchange solutions to their management. Don't let foreign exchange exposure be the reason you don't make your numbers.

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Foreign exchange transactions can be highly risky, and losses may occur in short periods of time if there is an adverse movement of exchange rates. Exchange rates can be highly volatile and are impacted by numerous economic, political and social factors, as well as supply and demand and governmental intervention, control and adjustments. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. Before entering any foreign exchange transaction, you should obtain advice from your own tax, financial, legal and other advisors, and only make investment decisions on the basis of your own objectives, experience and resources. Opinions expressed are our opinions as of the date of this content only. The material is based upon information which we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such.