

# Southern California Association for Financial Professionals

Foreign Exchange, Your Business, and FX Market Update

January 8<sup>th</sup>, 2010

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# Agenda

Global Expansion and Foreign Exchange

The Foreign Exchange (FX) Market

Currency Volatility & Risk

Examples

Managing FX Risk

Hedging

Market Update

# Accelerating Pace of Global Expansion

- Increase Sales
- Suppliers
- Low Cost Manufacturing
- Logistics/Outsourcing
- Expansion
- Capital

# Global Expansion – Issues & Risk Factors

- Financial Risk
- Operating Risk
- Compliance
- Tax
- Regulatory Risk
- Credit Risk
- **Foreign Exchange-Foreign Currency aspect unavoidable**

# Foreign Exchange and the Enterprise

- **Treasury Operations**

- Pay overseas vendors and/or employees
- Invest Capital & Fund Foreign Operations
- Channel Sales proceeds (A/R) denominated in Foreign Currencies
- Receive dividends, funded debt, & Return Capital denominated in foreign Currency
- Reliable and timely execution is critical

- **Risk Management**

- FX risk = Potential gain or loss resulting from movements in currency exchange rate vs. base currency
- Transaction, Translation & Economic/Operating Risk
- Examples: Laker Air, Allied Lyons, Nat'l Australia Bank

# Foreign Exchange Market

- Massive-Dwarfs all exchanges
- Global
- 24x7
- Unregulated Freely floating Currencies (vs. Restricted)
- Volatility
- Not Uniform
- Wholesale Market & Market Makers v. Small Bus./Retail
- Bid-Ask Quotes based on spot market e.g. bid \$1.4750; Ask \$1.4755 to purchase 1 euro (EUR). 2 day settlement
- --Duality-Currency Pairs (EUR/USD; USD/JPY and Inverse rates

# Major and Safe Haven Currencies

- Usual Suspects: EUR, GBP, JPY, AUD, CAD, CHF, etc.
- Historically the U.S. Dollar, Swiss Franc and Yen benefit when economic risks rise but not necessarily in tandem
- The Swiss Franc and the Euro gain against the U.S.\$ when certain geopolitical concerns surface
- In the current environment if we should get another dip in stocks look for the dollar to strengthen

# Commodity & Emerging Market Currencies

## The Commodity Currencies are:

- The Australian Dollar      The RBA commodity basket
- The New Zealand Dollar    Agricultural Products
- The South African Rand    Gold
- The Russian Ruble         Oil and Natural Gas
- The Brazilian Real         Oil, Minerals and Lumber
- The Canadian Dollar       Oil, Nat gas and Lumber  
(the problem with the C\$ is the Canadian reliance on the U.S. economy so it is not as closely correlated with commodities as the others)
  - \*The main influences are next to the currency
- Emerging market currencies include CNY, INR, BRL

# FX Rate Volatility-EUR 2009



# FX Rate Volatility-BRL 2009



BRL BRAZILIAN REAL SPOT G-1 Daily 1/2/09 to 12/31/09

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# Foreign Exchange Risk

- FX Rates change or fluctuate over time-Volatility
- Company subject to Foreign Exchange Exposure unless every current and future foreign currency transaction and balance sheet items is perfectly offset in terms of amount and settlement date.
- FX Exposure= potential for gain or loss resulting from fluctuation of exchange rates. Key factors; Amount, Direction, & Maturity
- Long and Short
- Impacts cash flow, profitability, and the balance sheet

# FX Currency Exposure-Basic Example

- Late 2008 company plans to transfer BRL 350,000 per month to fund its subsidiary in Brazil in 2009. This totals BRL 4.2Million for the year.
- As of 1/2/09 BRL 2.23176 = USD 1.00
- Equals \$156,827 per month or \$1.88 million for the year
- FX Exposure = Short BRL 350,000 per month or total short position BRL 4.2 Million

# FX Currency Exposure-Acquisition

- 6/8/09 Company requests Bank Financing to support acquisition of Spanish Company
- Purchase price = \$20,000,000 or EUR 14,388,489 at the current spot rate \$1.3900 = EUR 1.0000
  - Sale to close by October 2009
  - Settlement in dollars
  - 3% band vs. \$1.40 (\$1.358 - \$1.442) built into acquisition terms
  - Company defers on hedge
- August 13 EUR/USD deteriorated to \$1.4292
- FX Exposure?
- Short EUR 14,388,489?

# Manage FX Risk

Managing FX risk necessary to mitigate the potential negative impact of Currency volatility

Ignoring risk has several pitfalls:

- U.S. Companies with un-hedged foreign currency payables or receivables may experience earnings volatility and even lose money
  - U.S. exporter competitive advantage by invoicing in foreign buyer currency
  - Foreign suppliers may charge a premium to invoice in USD
  - Economic cost from loss in currency value (but gains are possible)
  - Translation gains or losses impact the balance sheet
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- Currency Hedging= strategy to insulate a company from exposure to FX rate fluctuations

# Steps to Managing FX Risk

## ANALYSIS

- 1) Data Collection
  - Define key questions
  - Develop collection system
- 2) Exposure Analysis
  - Quantify the exposure
  - Compare quantified risk to cost of hedging

## DEVELOP FX POLICY

- 1) Identify key features
  - Objectives
  - Guidelines
  - Hedging Tools
  - Internal responsibility
- 2) Communicate Policy
- 3) Regularly evaluate Policy

## CHOOSE METHOD

- 1) Adhere to Policy
- 2) Think Internal Hedge 1<sup>st</sup>
- 3) Be flexible
- 4) Use a combination of tools

## MONITOR EVENTS

- 1) Be alert to events that may affect FX markets
- 2) Identify new risk management tools

# Range of Hedging Strategies

- Do Nothing
- Natural Offset
- Operating Hedges
  - Invoice in home currency
  - Lead/Lag
  - Match receipts and payments
  - Match Assets and Liabilities
    - Offset long position with liability e.g. borrow foreign currency
    - Offset short position by pre-funding using cash or borrow USD
- Use Financial Hedging Instruments (next page)

# Financial FX Hedge Instruments

- **Spot Contracts** – Basic FX transaction. Hedge example pre-fund liability.
- **Forward Contracts** – A firm commitment to buy or sell a currency on a future date at a rate set today. Provides exchange rate hedging for known future cash flows. Window forwards can be designed to provide flexible settlement dates. Forward rate a premium or discount based on interest rate differential.
  - **3 month EUR/USD Forward = \$1.4413 spot - .0004 points = \$1.4409 forward rate**
- **Swap Contracts** – A simultaneous sale and purchase of a currency over two different dates; provides flexibility for clients with payables and receivables in the same foreign currency.
- **Option Contracts** – A contract that will provide the right, but not the obligation, to buy a currency (buy a call) or sell a currency (buy a put). This added flexibility results in an upfront charge or premium. Ideal for uncertain cash flows.
- **Structured Option Contracts** – A contract that reduces the premium cost but, in return, becomes an obligation. A collar that locks in a rate range would be such an option and is an alternative to a forward contract.
- **Non Deliverable Forward** – Offshore hedge instrument for restricted currencies.

# FX Currency Exposure-Basic Example

## Result

- BRL 350,000 per month for company's Brazil expenses in 2009 or BRL 4.2 million for the year.
- FX Exposure at beginning of year = Short BRL 350,000 per month or total short position BRL 4.2 million for 2009.
- At beginning of year spot rate of BRL 2.23176 = \$156,827 per month would be paid if that rate held for the entire year.
- Total Payments if no change in spot = \$1.88 million.
- Total actual Payments without hedge using spot on day of transfer = \$2.128 million. Extra cost = \$248,000.
- Total payments with monthly NDF hedge = \$1.720 million, or \$408,000 benefit against un-hedged payment stream.
  - BRL interest rates higher so BRL at discount on forward hedge

# FX Currency Exposure-Acquisition Result

- June 09 negotiated Purchase price = \$20,000,000 or EUR 14,388,489 at the current spot rate \$1.3900 = EUR 1.0000
- 3% Band: Max \$1.442 = \$20,748,201; Min \$1.358 = \$19,539,568
- Company considers hedge when USD deteriorates to \$1.422/EUR
- Company eventually hedges at \$1.45 capping payment at \$20,863,309
- Sale closes at \$1.5016 = EUR 1.000; Company remits \$21,605,755
- Delta vs. original max = (\$857,554) without hedge; vs. Hedged amount delta = (\$115,108)

# FX Market Update: What Used to Drive the Currencies

- Before the Meltdown two things were the most important drivers of currency values:
- International cash flows caused by investments
- International cash flows caused by Trade
- For the U.S. this was a matter of Trade Deficit versus the amount of money that was invested in the U.S ( The TIC Data- Treasury International Capital flows)

# FX Market Update

## 2009

- Market meltdown carry over/Credit Crunch impact liquidity
- Low U.S. interest Rate
- Weak US economy and outlook
- Perception of Risk impacts USD via demand for Treasuries, etc.
- USD as Carry Trade currency
- Negative correlation of equity markets to USD
- Extreme volatility
- Dollar Index down 7.9% through 11/09
- Dollar Index up 4% in December

# FX Market Update

## What to track in 2010

- Interest rates
- Relative GDP growth
- Speculator/Hedge Fund behavior (shorts and longs)
- Relative position of USD as reserve currency
- Commodity prices
- Continued overseas outflows by U.S. based investors
- Disruptive political or other event/Double Dip recession

## Can't ignore

- Government Debt/Deficits
- Inflation

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