



In search of the perfect hedge

A period of global currency volatility has been prolonged by the UK's decision to leave the European Union. The response of CFOs to this market turbulence has centred on a range of hedging strategies, as *Andy Davis* discovers.

After several years of relative calm in global foreign exchange markets, conditions have turned much more turbulent. The UK's decision to leave the European Union produced the biggest one-day movement ever seen in sterling's rate against the US dollar, sending it to a 30-year low.

The fallout from the UK referendum is expected to cause volatility in the value of sterling against other currencies for some time. But, well before this latest shock, other major shifts had taken companies by surprise. In the closing months of 2014, the US dollar in particular strengthened dramatically relative to most other currencies. For US-based multinationals, this had an immediate and unwelcome impact on the financial performance they would report to the investment community – an impact now likely to be reinforced among those exposed to sterling, and to the euro itself.

Various reasons have been offered for the turbulence that began in late 2014. Slowing economic growth in China and the resulting decline in demand for basic commodities had an effect. Growing signs of divergence between the world's major central banks were also a big factor – the US signaling a move to gradually raise interest rates, while the Eurozone and Japan remained committed

to monetary easing. Political instability, caused by events such as Western sanctions on Russia and the corruption scandal surrounding Brazil's Government, has played a part.

Whatever the precise cause, the effects were inescapable. According to the *FiREapps Currency Impact Report* for Q4 2015, the number of US companies in its survey that reported foreign exchange setbacks reached a record level, 66% higher than in Q4 2014. For the first time, the proportion of the FiREapps survey sample experiencing "currency headwinds" was above 40% for two quarters in a row.

In particular, US companies that generate most of their sales overseas suffered a major impact to their revenues and earnings because of the sharp appreciation in the dollar. In some cases, companies that managed to increase their international sales volumes by close to 10% nevertheless saw the value of those sales in dollar terms decline significantly year-on-year as the effect of a stronger dollar fed through.

The story was similar in Japan, according to the *Nikkei Asian Review*, with the country's exporters hit by depreciation in the euro and emerging market currencies. The publication reported that,

for the nine months to December 2015, about a third of the major nonfinancial corporations with March year-ends reported foreign exchange losses totalling US\$3.5b – three times their level a year earlier. More recently, a sudden jump in the value of the yen during June 2016, after the Bank of Japan's meeting produced no further monetary easing, will have hurt Japanese companies' foreign earnings further.

RAPID MOVEMENTS

The nature of exchange rate shifts, says Robert Royall, Derivatives and Financial Instruments Solution Leader in EY's Financial Accounting Advisory Services team in New York, is that they are rarely smooth – as the instant reaction to the UK referendum result demonstrated. "It's a jolting journey along a general trend," he says. "From December 2014 to March 2015, the movements were astonishingly rapid and the dollar strengthened much faster than anyone thought it would." An issue that had previously been the preserve of corporate treasurers was now a central issue for CEOs and CFOs in their conversations with the financial community.

Royall explains that US companies whose reported earnings in dollars had benefited from a gradual weakening of the US currency since about 2002 now began to ask whether they should hedge their foreign currency exposures – and, if so, how. There are various approaches to the problem, although none gets around the basic issue in hedge accounting that a simple translation of revenues or profits from one currency into another for the purposes of consolidated reporting cannot be hedged. But where companies transact across borders from one currency to another, hedging can help.

The most obvious approach is to take advantage of any "natural hedges" within the business; for example, where a subsidiary generates revenues in a foreign currency that it can also use to pay for costs incurred in the same currency. Natural offsets of this sort provide a measure of protection. Crucially, though, in a large and complex international corporation with scores of subsidiaries and a global supply chain, harnessing them can be highly complex and depends on having timely information about where and when the company is generating and spending cash.

"Prior to the past two years, companies generally had that information on a monthly or quarterly basis," says Royall, "but in 2015, exchange rates moved so dramatically within a month that this wasn't good enough for some companies. They wished they had daily – or at least more frequent – information."

A ROLLING HEDGING PROGRAM

Natural hedges are an important part of the approach taken by Abbott, the US-based health care company with extensive emerging markets operations. Since its demerger from the pharmaceutical company AbbVie at the end of 2012, Abbott has had much greater exposure to

emerging market currencies, according to its CFO, Brian Yoor. This is a necessary condition of its long-term strategy to benefit from growing demand for health care across the developing world.

Where possible, says Yoor, Abbott's strategy of serving markets better by increasing its local presence – expanding sales and marketing teams, manufacturing, and even opening R&D and administrative centers – not only matches costs more closely to the spending power of local customers, but also has the beneficial side effect of creating bigger natural hedges within the business. "It serves the need to find as good a natural offset as you can," says Yoor, "but at the same time, it's tied to your long-term strategy, and for us, strategy comes before all."

The demerger created a business with 70% of its revenues outside the US and 50% in emerging markets. Although natural currency offsets were important, Abbott's management realized they would also need to manage the company differently, Yoor explains. Having previously taken a "more opportunistic" approach to hedging, Abbott now put in place a rolling hedge program that looked 18 months ahead. "We went through to see where hedges were available in certain countries and whether they were affordable. Can we get the hedge accounting treatment that we want? Is it a liquid market?"

The hedging program cannot provide the same perfect match as a natural hedge, but it served

Is currency volatility here to stay?

Vodafone's Group Treasurer Neil Garrod observes that adjustments in exchange rates are one of the key means by which economic rebalancing between nations takes place, but argues: "What we're doing – with quantitative easing, with the Bank of Japan, with currency pegs in China – is that we're actually stopping that natural balancing effect from occurring."

He believes that major exporters such as China and Germany should have much stronger currencies, based on their economic fundamentals, and that the barriers preventing these "structural imbalances" from correcting themselves create the potential for violent exchange rate adjustments in future.

Abbott's Brian Yoor points to multi-year cycles of strengthening and weakening in the US dollar: "We're on the longer end of what will have been a strengthening cycle for the US dollar – I think some of the longest periods were seven years and we're in year five," he says. "I'd like to think that the bulk of the decline in some of these non-US currencies is behind us. Some of them weakened by close to 50% in a two-year period."

Abbott well during the turbulence of 2014-15, says Yoor: "We were able to use a blend of certain instruments that generated income for us in a very volatile environment and enabled us to continue to invest in the business." He adds that Abbott investors understand that the benefits of a rolling hedge program will change over time; for example, as hedges taken on 18 months earlier start to expire and are replaced by new positions that may be more expensive. "You're still realizing a benefit, but it's not as much year-on-year," says Yoor.

ECONOMIC HEDGES

Like Abbott, Vodafone Group has recently undergone a transformation that changed its currency profile, with the sale of its stake in Verizon

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Robert Royall, EY

Wireless in the US. The mobile telecom company that emerged reported its results in sterling but had half its revenues in euros, 15% in sterling, 10% in rupees and another 10% in rand.

CFO Nick Read says that, in the last full year, currency movements reduced reported revenues by about £2b and earnings before interest, taxes, depreciation and amortization by about £700m. However, with its longstanding exposure to emerging market currencies, which are prone to volatility, the company has developed an approach to managing its currency risk that has several strands.

Part of this involves "economic hedges," says Read, in which Vodafone matches the currency mix of its debt to the discounted cash flows of its various foreign subsidiaries. "What that means is that a negative impact on the P&L provides us with a reduced or

positive impact on our net debt, which reduced by £2b [last year]. So there's an economic hedge."

The company manages its global procurement centrally, reducing the exchange rate risk of purchases priced in emerging market currencies by converting the contracts into local currency payables. In this way, it avoids negotiating in euros and risking a translation hit through the rest of the year.

Read says that Vodafone's policy is to report on its "organic performance" and then to isolate the impact of currency fluctuations to make them clear. Investors have a good grasp of the effects of currency volatility on Vodafone, he argues, pointing to the close relationship between movements in the company's sterling-denominated share price and changes in the sterling to euro exchange rate. However, given that half the company's revenues are now generated in euros, in April 2016 it switched its functional currency to euros instead of sterling and announced that, in future, it would also declare dividends in euros rather than sterling. This should result in less volatility in Vodafone's reporting and also means that it will no longer be generating cash flows largely in euros but paying dividends in sterling. The change effectively passes inherent exchange rate risk from the company to its shareholders.

"I polled institutional investors on their support for moving to euros and they were overwhelmingly in favor, given that they can manage the currency risk from their end," says Read.

WHAT'S YOUR APPROACH?

Royall says that the foreign exchange (FX) volatility leading up to the UK's EU referendum and the repercussions afterward illustrate that the issue of managing FX risk is still a live one. "There's an uneasy calm at the moment," he says. "A year ago, everyone's consciousness was raised about how bad the movements can be and a lot of companies started to

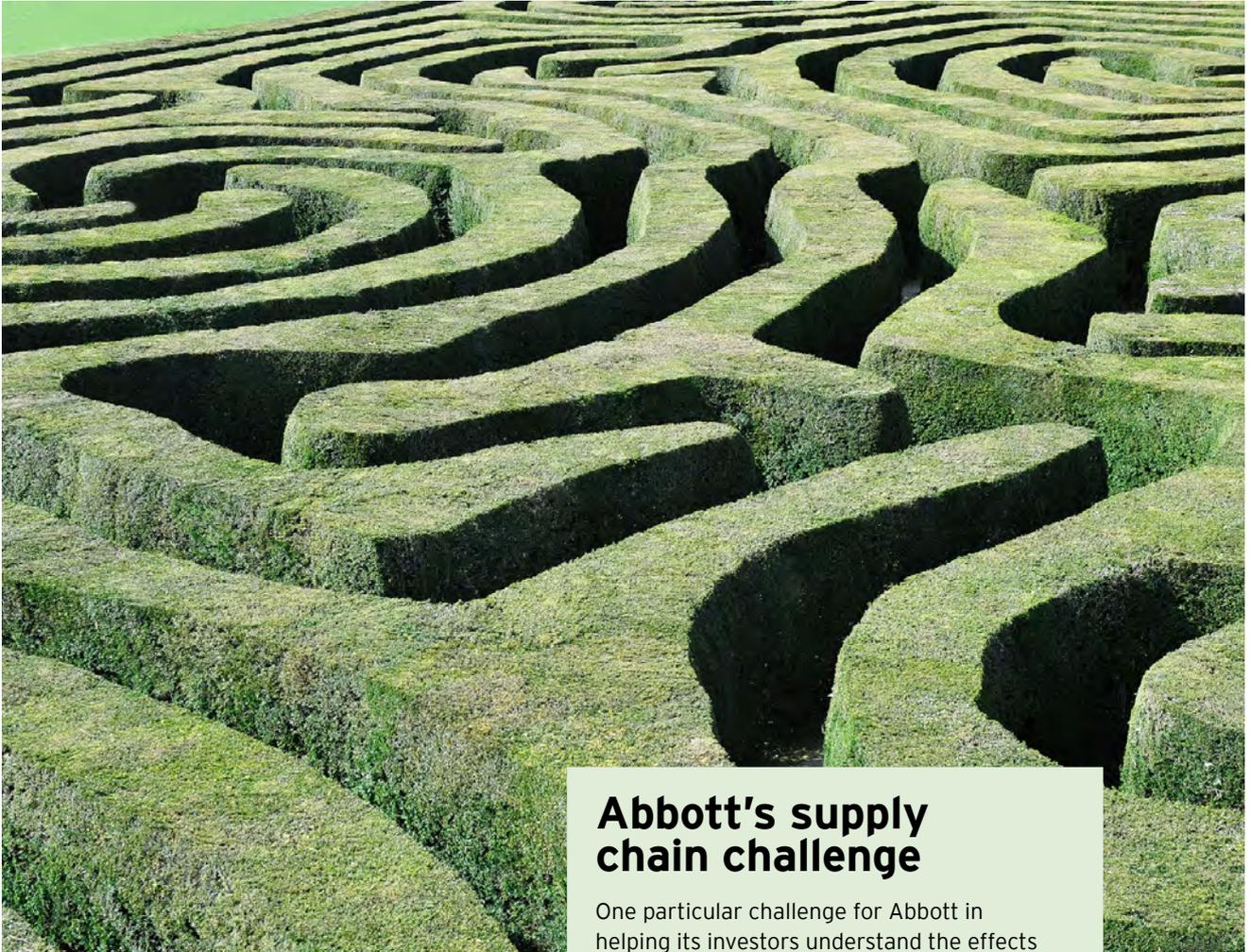
How Vodafone factors currency risk into its investment decisions

A central element of Vodafone's approach to managing currency risk in its investment decisions is its use of a specific weighted average cost of capital (WACC) for each market it analyzes.

Group Treasurer Neil Garrod explains: "The evidence suggests that real interest rates are not globally consistent and that the real interest rate in Nigeria, Ghana or India will be higher than the real interest rate in dollars and euros." These differences reflect the risks – including currency volatility – of investing in those countries. So,

by basing its assumed WACC for each market on the real interest rate in that market, Vodafone aims to capture the risks of investing there and so set a realistic hurdle for the returns it needs to generate.

"Lots of corporates apply the group's WACC, which is completely wrong," says Garrod. "You need to be rewarded for the territory you're in, and those territories have higher real rates. There are a couple of reasons, but a big one is currency risk."



Abbott's supply chain challenge

One particular challenge for Abbott in helping its investors understand the effects of currency volatility on its reported earnings is the global nature of its supply chain. Although investors might expect a change to feed through immediately to reported revenues, a great deal depends on where and in what currency the inputs for products manufactured were incurred and the quantity that is held as stock within the supply chain, says CFO Brian Yoor. As a result, it may be that Abbott can only fully appreciate the impact of changes in various exchange rates on the margins it ultimately generates from its sales some months later.

"When we talked to investors this year, they saw, for example, improving exchange rates in some of the emerging markets and their immediate tendency is to say, you should be increasing your earnings," says Yoor. "That's a fair point, but you can't just use a straight translation model, because there's the lag effect of the inventory that's already in your supply chain, which has been sourced in various locations and currencies. Therefore, if things were to stay as they are from the point at which we have that discussion, you'd likely see more favorable profit from translation anywhere between two to three quarters out.

"We had those conversations with investors and it took a while. It probably took a year for them to get comfortable."

ask themselves, 'What's our philosophy about foreign currency?'"

That is the question they must all ultimately answer, he believes. "The issue is volatility, not what the long-term trend is. Hedging doesn't reverse the long-term trend; it helps to smooth the jolts along the way. You have to decide if hedging is something you believe in or not."

Some companies will feel they need as much protection as possible; others will take the view that currency swings are part of being a long-term international enterprise and that currency volatility tends to even itself out in the long run. But whatever their view, CFOs of multinational companies will need to continue focusing on the twin challenges of managing currency risk and ensuring that they are communicating their approach to this complex, multifaceted problem as clearly as possible.

Companies have a variety of tools available to help them manage currency risk, but they can never escape the effects of volatile exchange rates entirely. The key is to keep reassessing whether they have the best mix of measures to address their particular exposure, and to redouble their efforts to help investors understand the hedging philosophy they are acting upon and the reasons underpinning that philosophy. ■

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