The Advisor – Fall 2016

Foreign Currency Hedging

Most businesses face some degree of foreign currency exposure – whether it's selling into other countries or purchasing goods and services abroad. The question is what strategy should you implement to deal with this risk? Let's assume that a Canadian based company has customers and suppliers located both in Canada and the United States. The company has $300,000 a month in U.S. denominated sales and $500,000 a month in U.S. denominated purchases, leaving them with foreign currency exposure of $200,000 U.S. a month. The company could follow one of four common FX strategies:

1. **Do Nothing.** The company would collect U.S. dollar receivables and pay U.S. dollar suppliers when they come due. Management would have to purchase (or borrow) $200,000 in USD a month at the spot rate to pay for its remaining U.S. purchases.

   This is the simplest strategy as there is no tracking of FX rates or hedging contracts. The downside to this strategy is if the FX rate moves the wrong way, it could shrink your margins significantly.

2. **Develop a Natural Hedge.** This involves making a conscious effort to equalize the company's foreign based receivables with its payables. In our example, the company should focus its efforts on increasing its U.S. based sales by at least $200,000 a month so that cash collected from U.S. sales will fully offset the cash required to pay its U.S. payables. Alternatively, management should attempt to decrease its U.S. based purchases by $200,000 a month by using Canadian based suppliers instead.

   When done effectively, this strategy is the best and cheapest alternative to managing a company's FX exposure. However increasing U.S. based sales or decreasing U.S. based purchases doesn't happen overnight and is easier said than done.

3. **Fully Hedge Your Foreign Currency Exposure.** This strategy requires that the company purchase forward contracts at an agreed upon price from a counter party (such as a Bank) to mitigate its FX exposure. In our example, management would purchase forward contracts to buy $200,000 in USD at agreed upon rates in each of the next six months. As each month progresses, a new contract is purchased so that the company is always fully hedged for six months in advance of the current month.

   The main advantage to this option is cost certainty. You can lock in your margin and your FX exposure is mitigated. The downside is that if the FX rate moves in the company's favour, (in our example, if the Canadian dollar appreciated relative to the

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U.S. dollar) it would have been cheaper had management bought USD at the spot rate rather than at the rates agreed to in the forward contracts.

4. **Hedge Only a Portion of Your Foreign Currency Exposure.** This is the same strategy as that outlined in 3. but instead of hedging the full monthly FX exposure, only a percentage is hedged. Assuming in our example that management wanted to hedge 50% of its monthly FX exposure, it would purchase forward contracts to buy $100,000 in USD at agreed upon rates in each of the next six months. As each month progresses, a new contract is purchased so that the company is always hedged at 50% for six months in advance of the current month. The remaining $100,000 would be purchased at the spot rate prevailing in the month in question.

Aries Advisory usually recommends option 4. to our clients i.e. hedge a portion of your FX exposure and "float" on the remaining balance. In this way, you can eliminate a portion of your risk while participating in any positive swings in the spot rate on the balance you don't hedge. If the spot rate starts to trend negatively, you can always ratchet up the amount you're hedging as you go along. The breakdown between the hedging vs. floating percentages varies depending on your company's particular situation. Items to consider would include:

1. How far in the future the company's foreign sales and purchase commitments extend and if they're secured with a sales or purchase order or are just projections;
2. How large or small the company's gross margins are; and
3. Management's risk profile.

Our challenge as advisors is to change management's mindset from that of foreign currency strategy being a profit centre to a risk mitigation tool. Senior managers and owners understandably dislike situations in which a hedging strategy is implemented and losses occur. Rather than being upset about the losses however, managers should focus on the fact that in the long run, a properly executed hedging strategy usually mitigates foreign currency risk and reduces FX losses when compared to doing nothing.

Aries Advisory Group has extensive experience in implementing foreign currency hedging strategies. We will review your foreign currency exposure and recommend how much in hedging you should consider implementing based on your company's circumstances. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

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