



International Outlook

A PUBLICATION FROM GPS CAPITAL MARKETS, CORPORATE FOREIGN EXCHANGE DIVISION

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Budget Rates



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Cash Flow Hedging

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When it comes to managing foreign currency exposure related to forecasted transactions, the last couple years have been a rollercoaster ride for treasury teams. Due to heightened market volatility and untimely exposures, companies have become more uneasy about managing this exposure type than they were before the financial meltdown. Often, the right solution is cash flow hedging. In today's marketplace, it is critical for treasurers to focus on the economics of hedging when deciding on an appropriate strategy. Some recent cases solved by relatively simple cash flow hedging strategies illustrate the economic benefits of this hedging strategy.

The Economics of Cash Flow Hedging

Cash Flow Hedging allows a company to protect itself from exchange rate volatility in its forecasted transactions. An effective strategy matches up non-functional currency-denominated cash flows with an offsetting hedging instrument. At its core, the strategy lets a company match their budgeted rate with an achievable exchange rate in the market. Forecasted transaction exposure is the common hedging term for the risks related to anticipated revenues and expenses. Once an appropriate transaction forecast is compiled, cash flow hedging allows treasury teams to use this risk mitigation technique to protect margins.

Business Issues solved by Cash Flow Hedging

Case Study #1

GPS recently assisted a company that has ongoing operating expenses in Mexican Pesos. The company is able to adjust its budget rates once every six months. We were approached to determine a better way to reduce the variability in the spot rates



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they get each month versus their budgeted rates. The strategy recommended by GPS was very straightforward: On the day when the company sets its budget rates for its forecasted operating expenses, the company enters in to six new hedging contracts, one for each of the next six months. This allows the company to match up their budgeted rates with the hedged rates achieved in the market. Rather than let currency movements impact the company's future payment stream, the finance professional at this company has taken control of the situation. This allows the company to do what it does best- make money operating as a producer of widgets rather than win or lose on market movements.

Case Study #2

Another company with sales throughout North America was able to benefit from cash flow hedging. The company has significant sales into Canada through its catalog, which lists product prices that are set at the beginning of each year in Canadian dollars. Two problems related to currency arose from these sales in Canada. First, the stream of cash flows generated from these sales was fluctuating each month primarily due to currency movements rather than to increasing or decreasing sales. Since catalog prices can't be changed mid-stream, at times, a weaker Canadian dollar ate into the margin budgeted when prices were set. Second, the timing of customer payments was often lagging and inconsistent. To solve these problems, we utilized a two tier strategy. Initially the client locked into a series of

Forward Contracts with a 30 day delivery window. But rather than locking into their entire forecast the client layered in the purchases 100% the first quarter, then 80%, 70%, and 60% in the subsequent quarters. This allows them to adjust and add to their position as they go along and have a better idea of not only their actual sales, but their clients' payment patterns. This cash flow hedging strategy was implemented the day the company set its catalog prices. On that day, the company put on a strip of window forward contracts to sell Canadian dollars and buy US dollars, one for each month of the year. The window forward gives the company a single rate that matches the budget rate used to determine catalog pricing and a flexible period to compensate for inconsistent payment timing. The company can now focus on regional sales performance rather than worry about the Canadian dollar moving one way or another.

While these two cases were solved by relatively simple hedging solutions, your company's situation may require a more complex strategy. Regardless of the underlying business issue, your company will benefit from understanding the economics involved. Adopting relevant cash flow hedging strategies will help companies accomplish their goal of matching budget rates with forecasted transaction flows.