



International Outlook

A PUBLICATION FROM GPS CAPITAL MARKETS, CORPORATE FOREIGN EXCHANGE DIVISION

IN THIS ISSUE:

Budget Rates



By David Pierce

Director Business Development

Corporate Headquarters:

10813 River Front Pkwy, Ste. 410
South Jordan, UT 84095

800-459-8181

www.GPSFx.com

Volume 7: Issue 2 February 3, 2010

Creating an FX Risk Management strategy

By David Pierce, Director Business Development

We are often asked by our clients how they can develop a systematic and effective approach to manage their FX risk. Any company that decides to tackle this challenge and develop a truly comprehensive view of risk management and implement company policies in regards to managing this risk is asking to take on a huge task, but one that will pay dividends in the years to come.

FX Policy

For most companies the first thing that comes to mind when thinking about a comprehensive FX risk management strategy is creating an FX policy. Unfortunately, many companies stop at setting some very basic policies and procedures around who is allowed to enter into hedges on behalf of the company, and what type of hedges should be allowed. This is usually done as a necessary step to receive hedge accounting for a part of their FX management strategy, but should never be confused with the process of actually implementing a full strategy. That being said, what makes sense for a company to be concerned with when building the architecture for a full FX risk management strategy? We will offer a few suggestions, but as all companies are vastly different, so should their policies be. In this article, we will deal with the first step in developing an FX risk management strategy, identifying exposures.

Transaction Exposure

This is typically the first area of risk that most companies begin to notice. Transaction exposure arises from converting known and expected cash flows from cross-currency transactions. This is a result of regular ongoing operations of your business, and is usually a product of buying and selling product between two parties, and the transaction being denominated in something other than the functional currency of that party. A simple example of this type of exposure would be when a parent company manufactures a product in the US, and sells it to their German subsidiary in EUR's. Companies will have a timing difference between when they actually sell their



International Outlook

A PUBLICATION FROM GPS CAPITAL MARKETS, CORPORATE FOREIGN EXCHANGE DIVISION

Volume 7: Issue 2 February 3, 2010

product to either a subsidiary or the end user, and when they actually collect the funds for these transactions. You would also want to consider inter-company loans when looking at the transaction exposure of the company as well. In short you should consider anything that is a known current exposure that will settle in cash, and would impact the value of the functional currency of the entity that has the exposure, this can be either the parent or a subsidiary.

Most companies doing business internationally have this type of exposure. This is the most common type of exposure that companies hedge with somewhere around 80% of all companies choosing to manage this exposure. Transaction exposure also can have a significant impact on the income statement of a corporation. Having un-hedged gains or losses causing increased volatility on your income statement will surely lead to undesirable results.

Economic Exposure

Economic exposure is simply the overall risk to the company if exchange rates move significantly one direction or another. Here is a quick example to illustrate how this exposure can impact a company. We were working with a company at the end of 2008 whose sales growth into Europe had been nothing short of dramatic! This company had entered the market in 2001 selling large ticket pieces of machinery. It had several months lag between when items were ordered, and when they were ultimately delivered and paid for. Their only competitor was a Germany company. Along the way the Euro strengthened from .8250 to 1.60. until the middle of 2008. The cost of their product compared to their German counterpart had dropped in half during this time period. It was no wonder this company had gone from no market share in Europe to almost 60% market share in a multi-billion dollar industry. Unfortunately in mid-2008 the dollar took off like a rocket strengthening 22% in only a couple months. Suddenly this huge cash cow was now costing them a fortune, as they had sold units in Euro's for less than they could make them now in dollars.

Now this is not the most common type of hedge that companies enter into as FAS 133 hedge accounting is not available. But we would argue that this can have the most significant long term impact to a company of any exposure that exists. As the world becomes ever more competitive and global, taking a look at your long term competitiveness in the world marketplace is a prudent management practice.

Translation Exposure

Translation exposure is simply the process of translating a foreign subsidiaries balance sheet back into the functional currency of the parent for the purpose of creating a consolidated balance sheet for the corporation. Any gain or loss on this value is recorded in Cumulative Translation Adjustment, a subset of Other Comprehensive income in the equity portion of the balance sheet.

Companies need to translate foreign subsidiary expenses and revenues back to the currency of the parent for their consolidated income statement. This works a little differently, as each line item translates individually, and can change the net income of the subsidiary, and can incorrectly track the foreign exchange effect during a given period.

As translation exposure does not have a direct impact on earnings, many companies shy away from hedging this type of exposure between the parent and its subsidiaries. But we do see companies hedge this exposure especially when thinking of selling a division, or concern about the total equity of the company. Some company's also choose to hedge the translation exposure of their foreign subsidiaries. When doing this, it is important to realize that hedge accounting is not available for these type of hedges, and the tenure is usually kept short to minimize the impact on earnings.

Now that you have taken the time to identify all of your exposures, now work on a strategy for effectively managing it. This can be a lengthy process, taking into account risk appetite and future plans of the company. We will go into further detail on how to make these decisions in upcoming issues.