Down and out

Executive summary

- The speed of sterling's depreciation in the final weeks of 2008 took many by surprise. It is now particularly weak in an uncertain business environment which has affected most industries. As a result, forecasting errors have increased and some companies may, by default, find themselves overhedged.

The erratic course of sterling has shown little sign of stabilising in the opening weeks of the new year, even if its most recent progress has been more encouraging. The decision by the Bank of England's monetary policy committee early in February to cut interest rates to an all-time low of 1% had little impact on the market. After almost reaching parity at the end of 2008, the pound has since recovered some ground against the euro.

Despite the UK's widened interest rate differentials with Europe, David Lamb, head of treasury for foreign exchange services company No1 Currency, anticipates that sterling should now hold steady in the near term as the onus shifts to the European Central Bank (ECB) to address weakening economic conditions and falling inflation.

But risk sentiment is an unpredictable beast. There will inevitably be more bad economic news over the coming months. As Marc Cogliatti, currency strategist for foreign exchange specialist HiFX, observes, the pound "is still looking oversold and undervalued" and the recent recovery may have further to run.

"Nevertheless, it is still too soon to call a base for sterling and, as yet, the longer-term downward trend remains unbroken," he adds. As other analysts have observed, it is quite possible to have a protracted period in which the pound remains undervalued, rather than bouncing back quickly.

PESSIMISTIC OUTLOOK Analyst Michael Hart at Citi is more pessimistic about the prospects for sterling and expects its weakness to continue for some time. The UK is plagued with the same structural weaknesses as the US, but Hart points out that there is no incentive for investors to hold sterling as a "store of value" because it does not share the dollar's reserve currency status.

He says: "There is still an overinflated property bubble and enormous foreign currency liabilities – something that the UK shares only with Switzerland except that the latter is in a net asset position.

"This creates a rollover risk every month. The monetary policy options have also been pretty well exhausted. The banking system isn't healing yet and there are still writedowns and losses that have yet to come through the system."

In the long term, the UK is likely to benefit from exchange rate depreciation as it feeds through into improved competitiveness, says Hart. However, there have been signs that the Bank of England's monetary policy committee (MPC) has concerns over the speed of the most recent sterling sell-off. The committee's most doveish member, David Blanchflower, went on record to declare the market was wrong to assume that recession in the UK would be deeper than in any of the other G7 economies.

"His comments are unusual; it's not typical for an MPC member to make comparisons with other countries," says Hart. "It suggests that the committee may be toning down its language to prevent any further fall."

REPERCUSSIONS ARE SERIOUS This year began with sterling 26% down from its level against the dollar at the start of 2008 and 23% lower against the euro, with much of the decline occurring during November and December as sterling neared parity against the single currency. The sharpness and speed of the fall was unexpected, significantly exceeding the drop of 10% that followed sterling's ignominious exit from the ERM back in September 1992.

The repercussions of the weak pound have been serious for many companies. Motor manufacturers Ford and Vauxhall, which have seen sales of new vehicles plummet as the credit crunch has intensified, have nonetheless put through increases in their price list because of sterling's depreciation. While Ford produces engines in the UK, its cars are manufactured in the euro zone and so the group has felt the impact of the slide; Vauxhall also imports many of its vehicles and components from Europe.

WITH THE CURRENCY MARKETS GIVING STERLING A PASTING, TREASURERS CAN NO LONGER RELY ON FX HEDGING STRATEGIES SUCH AS VALUE AT RISK, AS **GRAHAM BUCK** REPORTS.

British Airways, which has warned that it is on course for an operating loss of £150m for the year to this March – its first fall into the red for seven years – cited the weak pound as one of the main contributing factors. An operating loss of £50m for the third quarter alone followed a charge of £56m relating to the costs of currency conversion caused by sterling's decline.

By contrast, Vodafone used the currency's depreciation to increase its projected operating profit for 2008/09 by £500m to between £11.5bn and £12bn. At the same time, the telecom group's net debt guidance has also increased, by £5.7bn to £33.5bn, because much of it is not denominated in sterling.

THE ONLY WAY IS UP The worst of the pound's fall may have already occurred, and treasurers should consider the possibility that the only way is back up, says HiFX's treasury consultant Kevin Lester.

He says that sterling swiftly fell below a number of "floors" late last year and could still move downward to test further levels. This makes it essential for companies to have a "robust policy" for hedging in place.

"In the current volatile markets, it's important to have a structure that enforces discipline," Lester says. "Even the best forecasters in the world can get it wrong much of the time."

Lester adds that it is interesting that even treasurers who use risk management techniques such as value at risk (VaR) admit to having been taken by surprise by the speed and sharpness of the slump in sterling.

"The weakness of value at risk is that it fails to take into account the possibility of extreme events," he says. "The systems and techniques are backward-looking, so they are based on past behaviour but are of less value in showing what could happen going forward, so even the very latest techniques may be unable to give a very accurate picture."

THE BANKING SYSTEM ISN'T HEALING YET AND THERE ARE STILL WRITEDOWNS AND LOSSES THAT HAVE YET TO COME THROUGH THE SYSTEM.

Indeed, a recent Wall Street Journal article on VaR likened it to an airbag that fails to work precisely when it is needed in a car crash.

The treasurer's challenge of accurately forecasting exposure when FX hedging has been made even more difficult by the downturn. Added to volatility in the foreign exchanges, businesses have suffered further pain on the sales side. Importers of goods priced in US dollars are particularly vulnerable to a double hit, with demand slumping in addition to the unfavourable exchange rate.

WHAT CAN BE DONE? So how can treasurers address the problem? Lester believes that extreme volatility serves to emphasise the importance of vanilla options in hedging. They help to protect the business from further downside, the treasury department can participate in the market as and when currency trends head back in the company's favour and its policy can remain flexible.

While an environment of extreme volatility makes it very risky to be locked into a forward contract, an option mitigates risk.

However, treasurers are often reluctant to use options, due to what they see as a heavy upfront cost that involves paying cash. Lester compares it with a premium for fire insurance that rises commensurate with an increased risk of fire.

But he believes that, while options may look expensive at first sight, they represent better value than many treasurers imagine and that there is a good case for arguing that they are still relatively underpriced.

A handful of UK exporters, which opted to remain unhedged, are now in a position to lock in current beneficial exchange rates for the longer term, says Joakim Lidbark, a director of the corporate solutions group for foreign exchange at Citi.

"Hedging emerging market currencies prior to mid-2008 was relatively cheap in terms of spot, forwards, volatility and liquidity," he reports. "If you wanted longer-dated hedges in place during 2007 or even the early part of 2008 it was a very good deal."

Many companies are now rueing a missed opportunity. "A lot of corporate clients are in pain right now," says Lidbark. "In fact, it's not just sterling that has fallen sharply – for example, the Australian dollar has fallen back sharply too."

At the time of writing euro/sterling, which weakened from 0.70 to 0.98 at the end of last year, had rallied to around 0.90, while Cable (the sterling/dollar rate), which went from $2.10 to $1.36 over a fairly short period, had rallied to $1.45.

In such an uncertain business environment, which has affected most industries, forecasting error has increased and some companies may, by default, find themselves overhedged as a result.

"Spot has moved, so how do you deal with that?" asks Lidbark. "You can take the decision to accept the present low level of sterling and forward-hedge; alternatively, you can refuse to lock in at the current rates on the basis that there will be a recovery, thus enabling you to keep any upside.

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"In hedging terms this is achieved by purchasing currency options. People have tended to shy away from optionality in the past for accounting reasons. When times get tough, however, they tend to look at economics and give it precedence over accounting, which is what is happening at the moment."

WHAT STRATEGIES HAVE FTSE 100 COMPANIES BEEN USING? Tesco's group treasurer Nick Mourant says the supermarket giant's policy is to buy forward currency for imported goods but not to the extent that it potentially puts the group in either an advantageous or disadvantageous position in comparison with the rest of the market. So if the group is buying French wine, it will only hedge for a period of six or 12 months if that is what the rest of the market is doing.

"The speed of sterling's depreciation in the final weeks of 2008 took everyone by surprise, even though treasury departments carry out VaR analysis," Mourant adds. "While currencies have generally become more volatile in the wake of the credit crunch, sterling is particularly weak."

THE PROBLEMS WITH VAR At broadcaster BSkyB, treasury manager Mike Hazell says he recognises the flaws in strategies such as VaR, which his group has managed to avoid. "Our policies are based on maximising hedging protection, irrespective of assumed volatility," he says. "We have not therefore been exposed when volatility has subsequently exceeded – and quite significantly – what might previously have been reasonable expectations.

"By the same token, we will continue to apply this policy of maximising hedging levels to ensure that we are protected against any further volatility. We hedge exposures up to five years in advance. So the impact of temporary – albeit potentially prolonged – periods of volatility and sterling weakness is smoothed over time. This shelters our plans from extreme exchange rate movements year on year."

Hazell acknowledges that increased uncertainty restricts the ability to hedge with certainty, but adds that the nature of BSkyB's business means that its currency flows are fairly predictable and it can hedge a high proportion of them in advance.

"One area in which we have seen increased focus is FX lines, with banks very aware of the potential size of mark to market positions that might arise on new deals," he adds. "While in our case, this has just resulted in increased lines, I imagine that less creditworthy corporates might find themselves restricted by the amount of deals that banks are willing to hold with them; these are probably the same companies that can't afford to see significant fluctuations in costs and revenues due to exchange rates, thus compounding their problems.

At software giant Sage, Andrew Griffith, director of treasury and M&A, reports that the group uses non-sterling earnings to pay down its foreign currency debt: "Our facilities were denominated in sterling with drawings in euros/dollars. We have redenominated some facilities in dollars and we are monitoring the rate carefully."

NEW TRENDS Although the general observation for treasurers is that banks' FX services haven't noticeably changed since sterling caught a chill, there is evidence of new approaches.

"One topic that we've discussed with clients is hedging their foreign investments – for example, a company with a subsidiary in the US," says Citi's Lidbark. "A revaluation of this US asset would have resulted in a major gain usually booked in equity. By putting a forward in place as a net investment hedge, many corporates hedged that foreign capital."

But he adds it has been apparent that forward hedge can potentially lead to huge settlement risk in terms of the cashflow when the forward contract expires. As a result, options are a viable alternative as it establishes "a line in the sand" in terms of cashflow. "At maturity the cashflow from a purchased vanilla option will either be positive or, at worst, zero, but certainly not negative," he says. "The same argument goes for asset managers, when hedging international investment portfolios."

Increased volatility means many corporates have become more interested in applying a more active management process when hedging currency risk, adds Lidbark.

"Factors such as the level of implied volatility, cost of carry and the relative under/overvaluation of a particular currency pair should all play a part in the determination of the most suitable hedge at any given point in time," Lidbark suggests.

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