Buying time

JOHANN KRUGER PUTS THE HEDGING OF FOREIGN PROFITS UNDER THE SPOTLIGHT.

Before the introduction of International Financial Reporting Standards (IFRS) for listed UK corporates in 2005, many companies routinely hedged foreign exchange (FX) translation of profits generated by overseas subsidiaries. However, since 2005 this practice has become virtually extinct. This article explores why this has happened and whether/how corporates should reinstate it.

From a broad corporate finance perspective it is commonly accepted that hedging forecast cashflow or profit exposures, while being a valuable tool, has its limitations. For example, in the absence of offsetting positives – such as local currency profit growth or a cheap source of product/service for export or profitable use in the rest of the group – continuing to invest in a country which suffers from perpetual devaluation of its currency cannot be justified indefinitely by simply hedging away the currency risk. Similarly, placing production facilities in a country that offers cost-effective labour may eventually no longer make sense if the currency appreciates too much despite the existence of hedging programmes. Hedging FX strategically simply buys time to allow management to make the required adjustments to achieve offsetting benefits, such as profit growth (through becoming more cost-efficient, or top-line growth), or to disinvest.

Nevertheless, the benefit of the certainty/protection provided by hedging should not be underestimated. Without it, management may feel pressured, purely because of short-term pain (in the form of volatility or adverse movements) inflicted by the financial markets, into making commercial decisions that it might not otherwise have made.

WHY HEDGE FOREIGN PROFITS? Hedging foreign profits is a subset of the question as to whether a foreign investment as a whole (i.e. the principal investment and profit flows/cash generated) should be hedged. If the financial statements of most FTSE 100 corporates are to be taken at face value (see Figure 1 on page 26), protecting the translated value of the principal invested in foreign operations is the primary aim of hedging foreign investments. One could be forgiven for considering this as largely an accounting issue. After all, investors in multinational companies expect to earn income from various jurisdictions, so the currency diversification is part and parcel of the risk they assume. However, there is much more to this issue. The following are some of the additional factors to be considered in relation to a foreign operation:

- protection of dividend pay-out;
- covenant protection (interest cover, net debt vs EBITDA (earnings before interest, tax, depreciation and amortisation)); and
- reduction of forecasting error (revenue, earnings per share, other metrics)

Protection of dividend pay-out

Companies usually pay out dividends in a single currency, the currency of the listed parent. They also often have a stated dividend pay-out policy. For example, a certain dividend growth percentage may be targeted, or a stated pay-out ratio. Growing dividends at a targeted rate may be compromised if foreign profits fall due to currency volatility. Targeting a constant pay-out ratio becomes more of an issue if foreign currencies depreciate in the latter half of the year, after which most of the foreign profits might already have been recorded at rates prevailing earlier during the year.

A hedge over the forecasting horizon – e.g. 12–18 months, would make it easier for a company to manage its shareholders' expectations and to implement commercial changes (in response to financial market trends) which might only take effect with a lag.

Covenant protection

- **Net debt to EBITDA covenant**. This typically requires using the year-end rate for net debt, while using an average rate for the year for EBITDA. Therefore, if the foreign currency appreciates significantly towards the end of the year, it may put this covenant at risk. This was a widespread problem at the end of 2008 when sterling crashed from near 2.00 to the US dollar to 1.35 at one stage. Many companies that had net investment hedges found that these did not protect their EBITDA numbers and had to implement costly solutions to protect against the even costlier implication of breaching covenants.

The best solution to this problem is to align the FX rate used for both sides of the covenant calculation. However, in the absence of this, a currency hedge would provide good protection.

- **Interest cover ratio**. This is at risk if foreign currencies depreciate at any time during the year, even when debt currencies are aligned to foreign EBITDA proportions. The first unit of the cover ratio covers the debt interest cost, which represents the area where foreign debt aligns cost and income. However, the excess profit over the first unit is where the risk lies, as it can contract sharply in the absence of an appropriate hedge.

Potential impact of profit forecasting errors

Listing rules usually require listed entities to provide trading statements. Equity analysts place a premium on good expectation management, and lower profit volatility is typically beneficial to a company's share price. However, even if it does not do so in isolation, adverse trading for commercial reasons could be exacerbated by FX volatility and may lead to profit warnings or negative surprises, with an adverse effect on the share price.

WHY IS HEDGE ACCOUNTING FOR FX RISK OF FOREIGN PROFITS NOT ALLOWED? During the International Accounting Standards Board's (IASB) "outreach" consultation project on the replacement of IAS 39 with IFRS 9, the issue of allowing EBITDA as a hedged item was discussed. EBITDA does not represent an identifiable cashflow that can be adjudged as highly probable or not. It is an approximation of a net cashflow, which is itself the result of gross cashflows from operations before capital expenditure, tax and interest, the probability of which depends on the probabilities of these underlying cashflows. Therefore, the IASB concluded that EBITDA cannot be an underlying item in a cashflow hedge relationship. In summary, systematic hedges of FX risk of foreign profits simply do not work under IFRS due to asymmetric accounting recognition of hedges versus foreign profits.

HOW CAN ONE SOLVE THIS ACCOUNTING ISSUE? Adjusted EBITDA would be a sensible way of reporting results, particularly if owners are private equity investors. EBITDA should not be adjusted for real losses. Reporting profits in constant currency equivalent to eliminate currency "noise" does not remove the practical effect of currency volatility. However, non-cash volatility that is expected to reverse in the future because there is a hedge which neutralises the market risk can be credibly adjusted out of profit numbers.

A possible strategy for executing a hedge would be as follows:

- **Step 1**: Hedge the target conversion rate when the forecasts are prepared for the following year. EBITDA (and net profit) translation is

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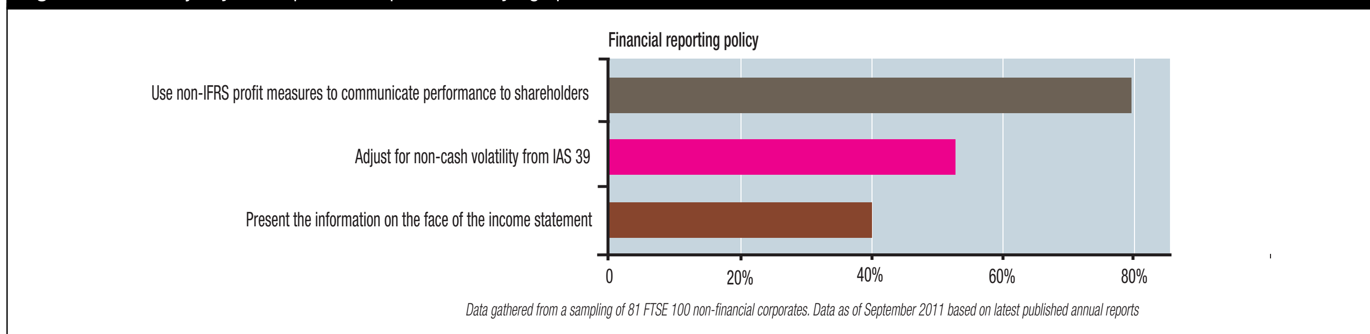
Figure 1: The majority of corporates report "underlying" profit



typically at month-end rates; the more this translation is mirrored in the hedging instrument, the better.

Note that an allowance can be made for underperformance. Such an allowance can either be in the form or hedging less than the expected profit, or by using option-based instruments to avoid being locked into FX rates on foreign profits which do not materialise.

A strip of 12 FX hedges with 12 expiries/maturities, one at the end of each month, is needed for each year that is protected. This could be achieved, for example, through one of the following:

- a strip of forward contracts;
- an average rate option, where the payment upon final expiry is based on a comparison of the average rate at the 12 monthly observation dates to the option strike; or
- a strip of vanilla options.

Here, the third approach is typically more expensive than the second.

■ **Step 2**: Since the hedges cannot achieve hedge accounting under IFRS, one could accept IFRS P&L volatility, but adjust out the result until the instruments have matured against the realisation of underlying profits. For example – if FX contracts were used:

- after month 1 of the year, the EBITDA for that month is translated at the closing month-end rate;
- the first FX contract expires and is settled in cash;
- the gain/loss on that contract is an adjustment to EBITDA to arrive at "underlying EBITDA" , which is the subject of management commentary;
- gains or losses on the 11 remaining contracts are removed from the underlying EBITDA;
- after month 2, the process is repeated; and
- EBITDA for IFRS purposes is built up in exactly the same way as before, but each month a further FX contract expires and gets the underlying EBITDA back to the hedged levels.

The benefit of using this method is that it does not really matter which instrument is used to provide the hedge so long as an acceptable worst case scenario is guaranteed by the hedging instrument. For example, if the currently achievable worst rate is better than the forecast rate, the entity has scope to use average rate options, vanilla options, cylinders or other participating FX contracts to hedge and potentially achieve an FX gain. This is especially possible where the forward points are in favour of the entity – i.e. when the foreign currency sold has low interest rates.

80% OF FTSE 100 COMPANIES USE A TYPE OF ADJUSTED PROFIT AS A MEASURE TO REPORT PERFORMANCE.

Missing covenants can be more detrimental than missing profit forecasts. The above solution needs to be modified in the context of the covenants of each entity. Banks and bondholders should be happy with this kind of hedging, given the protection it affords the entity's ability to repay the debt.

AN ACCOUNTING SOLUTION WHICH ACHIEVES PARTIAL HEDGE ACCOUNTING Using a cross-currency swap with significant coupon payments could transfer some of the protection afforded by a qualifying net investment hedge to the income statement. The foreign currency coupon payments under the swap can be reported as part of interest expense, leaving only the principal to be matched with the asset investment in reserves. This solution is superior to using plain FX swaps because of the reporting of coupons vs the treatment of forward points in FX swaps.

CONCLUSION 80% of FTSE 100 companies use a type of adjusted profit as a measure to report performance. This can be used to solve the common problem of FX risk of foreign profit and cashflow protection for which IFRS does not currently provide a solution, and is unlikely to provide one in the foreseeable future.

A company should always consider its underlying economic position as a priority and seek to achieve the best possible way of formally reporting its performance.

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