BUMPY RIDE

Volatility in emerging markets can be a big headache for treasurers. Fortunately, sound risk management policies and systems can minimise its impact, explains Paul Golden

On 13 February 2014, Renault held a conference call to discuss the company's Q4 2013 results. During the call, its CFO, Dominique Thormann, explained that the French car maker had lost €619m on currency exchange in the final three months of last year. Chief executive Carlos Ghosn is also on record as stating that exchange-rate volatility is one of the major concerns facing Renault in 2014.

Renault is not the only company to have suffered from currency volatility in the emerging markets. Depreciation of the leading South American currencies against the euro impacted German sportswear manufacturer Adidas last year and fluctuating exchange rates have affected other major corporations, including electronics conglomerate Siemens and drink makers Pernod Ricard and Coca-Cola.

Brian Welch, MD of UserCare Treasury Consultancy, says that three key factors have contributed to increased volatility in emerging markets since last year – alongside over-optimism, speculation and greed. These are:

- US monetary policy, specifically the threat of the reduction of quantitative easing, which has led to investors taking profits and selling their investments in emerging markets;
- Higher inflation and reduced economic growth in China and the Indian subcontinent, especially India, but also Bangladesh, Pakistan and Sri Lanka; and
- Weaker prices for commodities produced in emerging markets and those being stockpiled in countries such as China.

In May 2013, Ben Bernanke, then chairman of the US Federal Reserve, hinted at a reduction in the rate of the Fed's asset purchases. The prospect of higher returns on relatively safe dollar-denominated assets provided an incentive to investors to trim their emerging-market exposures. This resulted in a broad-based sell-off, increasing volatility across equities and fixed income, as well as currencies.

Fathom Consulting economist Konstantinos Venetis suggests that external and domestic imbalances in developing economies have also contributed to currency volatility.

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"The capital exodus puts the spotlight on individual countries' external imbalances and dependence on foreign financing – high current account deficits, foreign-currency denominated debt exposures," he says. "This is evident in the depreciation suffered by the so-called 'fragile five' [Brazil, India, Indonesia, South Africa and Turkey] during 2013, accompanied by a substantial pick-up in volatility."

Venetis continues: "Importantly, a number of emerging-market countries have experienced excessive credit growth in recent years. The wave of liquidity brought about by highly accommodative global monetary conditions was directly reflected in higher domestic leverage, thereby increasing vulnerability to financial shocks and creating a backdrop conducive to rising asset-price volatility.

"As the tide of loose credit conditions recedes, a regime of higher interest rates and slower GDP growth brings asset quality problems in the banking system to the surface. Domestic credit problems could be the driving force behind a new wave of capital outflows, fuelling another surge in volatility."

Venetis agrees that China's slowdown has influenced emerging-market asset valuations over the past three years. "The downshift in China's economic growth has particularly impacted emerging-market, commodity-exporting countries and related cyclical sectors, where steep price declines have gone hand in hand with increased volatility.

"It also has negative implications for emerging-market Asian exporters, which have simultaneously had to deal with erosion in competitiveness due to the sharp depreciation in the Japanese yen."

He adds: "The electoral cycle in a number of key emerging markets (Brazil, India and Turkey) has injected an additional 'known unknown' layer of risk. In addition, social and political turmoil in Argentina, Ukraine and Venezuela have contributed to a higher volatility environment for emerging-market assets."

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Impact on treasury

So what does all this mean for corporate treasurers?

"FX volatility is one of the many risks you have to consider within the portfolio of risks you have to deal with," says Lucie Harwood, group treasurer with FTSE 250 technology company Laird, which has operations in China. "You can try and manage it through hedging, but it's also about balancing your need to be in a country, maybe for proximity to a customer, versus the risk. It's about weighing up the risk and reward. Whenever you consider going into a new market or jurisdiction, you always look at the risks. For example, it may be that you need to consider regulatory risk, not just currency risk, so you have to take that on board in the way you operate as well."

According to Welch, the industries most affected by emerging-market volatility include mining and other raw material producers, and the processors and refiners of those materials, as well as the businesses dependent on those materials and selling the finished products to the developed economies.

"Where possible, companies will have financed country operations with debt, but there may have been an obligation to inject some equity capital into subsidiaries," he explains. "Counterparty risk is an inevitable cost of operating in those countries. In practice, the credit risk of dealing with indigenous banks is often no worse than with developed economies' banks and they will usually have knowledge of the local exchange controls and taxes. The downside is that their charges are often higher and local banking practices and technology are 'different'."

In the case of countries that have exchange controls, it is often difficult to deal in the local currency, let alone sell it forward or hedge it, adds Welch. "But it is sometimes possible to hedge the currency with non-deliverable forwards where the bank will allow a corporate to hedge a currency on the basis that, at maturity, neither party delivers the actual currency, but one pays the other the difference arising on the movement of the currency."

David Blair, an independent treasury consultant based in Singapore, refers to increased risks around liquidity, refinancing and customer credit as examples of how treasury has been impacted by emerging-market currency volatility. His advice is that best practice requires managing risk (for example, hedging currencies and insuring receivables) even in times when it is quiescent.

"Emerging-market interest rates can be high and hard to benchmark, and hedging costs will be higher than in developed markets," he says. "Also, credit insurance may be harder to procure and more expensive. These are part of the cost of doing business in emerging markets. If such costs are not offset by higher margins, there should at least be a conscious decision to accept lower or negative risk-adjusted returns during the market-entry phase."

Jiro Okochi, CEO and co-founder of treasury and risk management provider Reval, says that expanding into emerging markets can be an eye-opening experience. "Something as simple as getting a complete cash position can take a day, or even a week, if companies cannot connect to the local banks with which they are required to do business."

In this context, reconciliation and true liquidity management become even more challenging, according to Okochi. "Cash pooling has become an important requirement for both global bank providers and system providers. Tax and other regulations vary across all countries, and companies with cash in emerging markets are not optimising their liquidity without the ability to physically or notionally pool funds."

Okochi says treasurers can help their cause by pushing for greater

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standardisation and automation. "Malaysia, for example, has a government-led campaign to create regional treasury centres to compete with Singapore and Hong Kong, and that has already driven better practices."

Craig Martin, executive director of the Association for Financial Professionals' Corporate Treasurers Council, observes that last year some US companies implemented currency options (contracts that grant the holder the right to buy or sell currency at a specified exchange rate during a specified period of time). But he accepts that implementing even a basic option strategy is difficult for many corporates because management has an anathema towards the option premium.

Daniel Blumen, a partner with Treasury Alliance Group, says emerging-market currency volatility has highlighted the importance to companies of doing upfront due diligence before they invest in, or do business with, emerging markets. This is partly so that they become familiar with payment mechanisms and infrastructure and banking practices.

Natural hedges

"Any company involved in emerging markets should look for, and use, natural hedges wherever possible," Blumen explains. "Because there are typically limited opportunities to hedge emerging markets using bank products, natural hedges are an important tool, but one that is often overlooked, since there are no 'salespeople' attempting to sell them to treasury. This is not a time to be without formal written policies or the visibility and control gained through a treasury management system."

Harwood predicts that companies will increasingly make use of natural hedges in future. "Any treasurer should consider natural hedges as part of their overall FX management process," she explains. "The first step is to match out your cost base and your sales currency. But it isn't always possible, so you have to look at other options, such as borrowing locally or seeing what costs you might be able to cover in other currencies.

"But you have to be careful with that. Sometimes people think they've gone away and matched out currencies, but actually all they've done is created an embedded derivative within their purchasing contract because there may be market-driven trigger events that impact how the pricing fixes in. It's actually about trying to protect your margin, and if you know you have volatility in your revenue – because it's in a different currency to your cost base – you need to try to lock in at least part of that cost base to try to protect your profit margin."

Whether they use emerging-market or G7 currencies, most companies do not have an expense budget for options and that results in them either being over-hedged by swapping or under-hedged by not swapping, says Okochi. "Since volatility drives up the price of an option, and volatility in emerging markets is higher, most treasury departments do not want to pay up for the option. But you could easily argue that, given the volatility, it is worth the price."

Martin says corporates would be unlikely to take up flexible hedging options. "It is hard enough for treasurers and risk managers to convince their board to implement a basic options strategy. As a consultant acquaintance of mine observes, no one knows where currencies are headed, so why not start by hedging 50% of your exposure?"

Nevertheless, he believes that some corporates would benefit just from getting a proper sense of their exposures. As he puts it: "There are companies that are only recently exposed to FX as a result of international expansion and this introduces new risks to the business."

THE PERILS OF POLITICAL RISK

Some companies face direct political risk, which may warrant insurance, observes consultant David Blair. "Others may find that political risk insurance is a worthwhile proxy hedge for other, more specific risks. But, like all proxy hedges, there may be a lot of basis risk and almost certainly no hedge accounting."

If political risk is critical, it should be in the company's enterprise risk framework, which may or may not be driven by treasury, adds Reval's Jiro Okochi. "Presumably, this insurance is very expensive where companies need it the most and, like any hedge, would have to be evaluated in its entirety with the exposure."

Stephen Kay, from Marsh's political risk and structured credit practice, says the key factor for a company considering political risk insurance is whether its exposure to a specific emerging market or region is material, which is probably the case if revenues equate to 25% or more of total turnover.

"Over the past year or two, doubts have started to emerge around the emerging-markets story and there is a much greater distinction being drawn between different countries. This has heightened awareness of risk and driven some companies to consider political risk cover for existing investments that may not have been insured previously, as well as for new investments," he concludes.

Look out for our profile of Lucie Harwood in the June issue of *The Treasurer*.

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