Like any hedging strategy, net investment hedging (NIH) is a tool for companies to achieve the shape and desired levels of foreign exchange (FX) risk. From an accounting perspective, the term is used for the hedging strategy by which an entity creates a short position in a foreign currency to offset the risk of the foreign investment—either from translating the original investment, or from converting operating cashflows to the parent company functional currency, which is also typically the group presentation currency. In practice, a company could borrow in the foreign currency (directly or swapped), depending on availability and the all-in cost, and/or increase the short position beyond available debt through the use of derivatives. Most companies’ annual reports articulate three drivers for NIH:

- concern about the balance sheet translation impact of foreign subsidiaries;
- hedging cashflows or earnings before interest, taxes, depreciation and amortisation (EBITDA), and
- cost/value-driven funding—borrowing in the currency with the lowest interest rate.

AUGUST 2008 SAW STERLING’S ERA OF STABILITY END WHEN IT PLUNGED INTO ITS PRESENT PERIOD OF VOLATILITY. AS A RESULT, NET INVESTMENT HEDGING PRACTICES HAVE BEEN UNDER INTENSE SCRUTINY, SAYS JOHANN KRUGER.
According to Lloyds’ research, companies continue the practice of NIH. Over the last three years, although businesses may have changed the magnitude of NIH, the research shows only a marginal decrease in the practice among FTSE 100 companies (excluding financial services groups) despite the significant increase in FX volatility of debt portfolios containing foreign debt. Another key finding is that there is no change in the proportion of FTSE 100 companies which continue to top up foreign borrowing using derivative overlays. Also, companies which indicate balance sheet translation as the key driver for hedging far exceed those who cite earnings/cashflow distribution. In part this may be driven by the limitations of external financial reporting, although there may be deeper underlying reasons for this trend.

CRITICAL CONCERNS In practice, and as confirmed anecdotally over time, the key concern for treasurers appears to be the earnings or cashflow misalignment at a group level in a given currency, rather than the effect FX revaluation has on their group equity. Companies commonly issue foreign currency debt or swap domestic currency debt to a foreign currency. But several supplement their foreign debt position by transacting additional net investment hedges on top of their available domestic currency debt. This indicates that companies consider NIH as a valuable risk management tool beyond simply modifying the composition of the debt portfolio.

In ascertaining the appropriateness of NIH for their business, companies must consider several factors. First, during the early years of overseas investment, cashflows generated by the overseas activities are typically reinvested locally. This will change though, as the business matures and becomes cash-generative or when there are plans for a disposal. In those situations, NIH may become advantageous because it will then provide certainty of cashflows and not just of an accounting balance in group equity. Companies often use the payback period as a measurement to decide whether a project is viable. Considering an acquisition or building of a foreign subsidiary as a project, it would make sense to hedge the investment so that the payback period can be accurately forecast and only subsequent profit is subjected to FX volatility. As soon as the first dividends are repatriated, the hedge can be scaled back to a level more consistent with subsequent EBITDA contribution.

Second, revaluation of foreign currency debt when the group’s functional currency depreciates can affect the debt covenant headroom significantly, especially net debt vs EBITDA, as EBITDA from foreign sources is calculated based on an annual or monthly average FX rate, whereas net debt is typically calculated at the year-end FX rate. This has the potential to lead to a covenant breach and a technical default. A pre-authorised solution by the board coupled with monitoring procedures would ensure corrective actions can be taken in a timely manner. However, the best solution to this problem is to negotiate a covenant that, as far as possible, neutralises the accounting asymmetries caused by FX volatility. For example, use the same FX rate to translate EBITDA, and net debt as the leverage ratio is the main culprit. Headroom on multi-currency banking facilities can also suffer from currency volatility. The answer would be always to draw in one currency and use longer-dated currency swaps. However, this solution sometimes reduces flexibility and creates exposure to currency basis risk, which has become larger and more volatile since 2008.

BEWARE THE PITFALLS The accounting treatment of NIH is relatively straightforward, but not without its pitfalls. Hedge accounting is available up to the net book value of overseas investments, which includes the equity investment and any long-term intercompany accounts. To the extent that an entity wishes to hedge a larger amount due to EBITDA flows, or a strategic exit decision of a low book value but high intrinsic value business, hedge accounting is not available. For example, overseas businesses purchased cheaply and non-capital intensive foreign businesses would suffer from this problem.

Even when a group reports and comments on “underlying profit” in addition to IFRS profit, NIH numbers are typically large and could still cause a dividend trap – a situation where an unrealised loss on a hedge for an individual entity is not offset by the gain on the (as yet) unrecognised underlying hedged item, and reduces or wipes out distributable reserves, thereby limiting the entity’s ability to pay a dividend.

Figure 1: Hedging benefit of currency diversification

**Source:** Lloyds Banking Group

Figure 2: FTSE 100 FX hedging policies

(% of total companies surveyed* – previous years in brackets)

* Source: Lloyds Banking Group. Data from a sampling of FTSE 100 non-financial corporates, June 2010
Care should be taken with fixed for float currency swaps as splitting the currency and interest rate elements at execution is necessary to achieve hedge accounting.

Furthermore, treasurers need to take into account the impact of interest rate differentials. The evidence of forward bias in FX markets suggests that incurring debt in lower interest currencies reduces the expected interest costs and over the medium to long term those currencies do not tend to depreciate in line with what interest differentials suggest. In other words, companies should aim to be underexposed to debt in high coupon currencies, which presently includes the Australian and New Zealand dollars as well as the Norwegian krone and overweight debt in low coupon currencies such as the US dollar, the euro or the Japanese yen, especially when those currencies are at cyclical highs. Although historically sterling interest rates have not been as low, current low market forward interest rates position the UK currency as a borrowing currency, which suggests UK companies with overseas investments can afford to have a GBP debt portfolio even if they are active in other markets.

Finally, FX risk is not additive. Any NIH programme should take account of natural offset and diversification benefits due to the less than perfect correlation of currency pairs. For example, a company that has factories in China and Malaysia and sales in the US, Europe and the UK may find that there is significant offset between the cost and revenue currencies (in terms of EBITDA flows) as well as diversification benefits because US dollars, euros and sterling are not perfectly correlated relative to its base currency. Figure 1 shows (for a model portfolio with the euro as the base currency and given certain assumptions on correlation and volatility) how diversification benefits could reduce the total amount of hedge required. The lower the correlation between currency pairs, the less hedging is required. Since correlations change over time it is usually best only to take credit for a portion of the calculated diversification benefit.

As detailed in this article, the NIH approach can yield tangible benefits to companies, such as better risk management and potential costs savings. Nevertheless, treasurers must think carefully about the processes and practical implications of implementing NIH as the appropriateness of adopting the strategy will depend on the situation the business finds itself in. Seeking advice and problem-solving expertise in this area is a step treasurers ought to take.

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