LOST IN TRANSLATION?

HEDGING CAN HELP UK COMPANIES TO ENSURE THAT A FLUCTUATING POUND DOESN'T HIT THEIR PROFITS, SAY WILL HASSAN AND MIMI RUSHTON

In the first six months of this year, UK companies issued 137 profit warnings. This was the highest number of profit warnings in the first half since 2011 and, according to EY's *Profit Warnings* report, adverse currency movements partly contributed to over a fifth of them.

Since mid-2014, the UK's economic recovery resulted in the pound strengthening considerably against the dollar, the euro and most other currencies. During the 12 months from July 2013, the pound jumped 13% against the dollar and 10% against the euro. Against emerging-market currencies, the movement was even more pronounced due to the innate volatility of those currencies.

The UK's economic rebound was reflected in its currency in a relatively short space of time. Meanwhile, the pound's rapid rise caught out many businesses that translate their foreign earnings back into sterling. Businesses without a translation-risk hedging strategy in place may have seen their net international earnings take a hit due to currency movements.

Profits are not the only thing to have suffered as the value of the pound soared. The adverse impact of currency movements on earnings can impact on other financial metrics – for example, net debt to EBITDA. Rated companies can find they are downgraded as a result of a negative shift in this metric, which will subsequently increase their borrowing costs.

To date, there has been an expectation that investors have generally been prepared to accept currency risk as an inevitable by-product of a company having an international footprint. But the magnitude of the currency movements over the past year – and the impact on underlying profitability that has been reflected in profit warnings – has started to unsettle investors, which has led to share prices falling.

Investors are increasingly asking what companies are doing to manage their translation risk so that it does not impact so heavily on the earnings of the business. This can be frustrating for CEOs and CFOs, who find their time at investor meetings is taken up with discussing earnings volatility due to currency moves when what they really want to talk about is the underlying performance of the business.

For all these reasons, hedging of translation risk is firmly on the agenda of UK companies with international operations.

The case for hedging

In the past, UK businesses have tended not to hedge translation risk as much as they should and during periods when currency markets are benign,

it can be easy to become complacent. But every company with an international footprint should always have a translation risk strategy – even if that strategy is to consciously not do anything. The reason for this is that it will be too late to put a strategy in place by the time the company has to report the impact of not having had one.

The following strategies are available to companies that are considering a more proactive approach to managing currency risk:

Hedging within an accounting period to manage positions

Financial derivatives can be used to directly hedge dividends that have already been announced or to secure sterling proceeds in line with any earnings guidance that may have already been issued. Since the hedging of earnings does not achieve favourable hedge accounting, some companies will choose to hedge within an accounting period. They manage their currency exposure over a six-month period between half-year and full-year results, hedging the exposure so that it aligns with the reporting date.

Tail-risk hedging to protect against extreme currency moves

This type of hedging is predominantly used to manage emerging-market currency exposures. Because emerging markets bring additional risk, hedging exposures in these economies using traditional instruments (for example, forwards) can be 'expensive' because they tend to have high interest rates. One way to mitigate some of that cost is to just protect against very extreme moves. For high-carry currencies, tail-risk hedging can be more cost-effective than using a more systematic forward hedging strategy, but it depends on the company's own circumstances.

Strategic FX trades that seek to outperform the current prevailing spot/forward rates

This route is for companies that are comfortable with remaining in the spot market rather than adopting a hedging strategy. They may seek to monetise this view via the use of FX options. It could be that they just have limited currency exposures or find that taking this strategy best suits their business objectives.

Aligning financing to foreign currency exposures

This solution entails aligning debts to assets as closely as possible in each of the markets in which your company operates. Foreign currency interest cost is a natural offset to foreign currency earnings. If you need to finance an overseas subsidiary and cannot borrow directly from a bank or the capital markets, your company could create a synthetic debt position in a foreign currency by using forwards. The forward contract qualifies as an investment hedge against the asset and therefore qualifies for hedge accounting. This strategy is particularly useful if your company has risks in emerging markets, but finds it impossible to borrow there. Furthermore, using FX forward contracts can be more efficient than borrowing debt in certain markets.

Taking a broad approach

Although companies can use financial instruments to provide all or part of the solution to managing their translation risk, they can also adopt other strategies. For example, they can look to overcome investor nervousness by providing the market with a higher level of disclosure regarding the potential impact of currency moves on earnings. The amount of detail they provide will depend on the extent to which their shareholder base feels comfortable with the level of international exposure that the company has.

There are even broader solutions to translation risk that companies can take. For example, they could reduce their international exposure by disposing of parts of their business that have tight margins and are no longer profitable because of currency moves. They can also look to invoice in sterling rather than in local currencies, if possible.

Above all, it is important to bear in mind that there is no 'one size fits all' when it comes to managing translation risk. It is up to businesses to address the risk on an individual basis.

POTENTIAL SOURCES OF EXPOSURE TO STERLING STRENGTH FOR CORPORATES

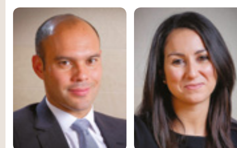
Corporates can be exposed to the strength of sterling in five main ways:

- **Translation of foreign currency earnings into sterling.**
- **Repatriation of foreign currency dividends back to the UK.**
- **Dividend payments to shareholders. This can be an issue when earnings are largely in a foreign currency, but dividends are paid out in sterling.**
- **Transactional cash flows. If large sums of money need to be paid out or received in sterling during the course of business operations, this can lead to translation risk exposure.**
- **Structural industry/economic FX exposures. This is where a corporate may make strategic decisions on how and where to invest, depending on the strength of sterling.**

HEDGING TRANSLATION RISK: IS IT FOR YOU?

- Identify the underlying currency exposures in your business and make sure you understand what is causing them.
- Get to know the sensitivities for the business with regard to currency moves – how and where is it affected?
- Ensure that your company has solid internal reporting in place. Monitor the activities of your subsidiaries and ensure that they are reporting on currency balances.
- Consider the requirements of investors and understand what information they want and the extent to which they expect to see a hedging risk strategy in place.

By taking the above approach, treasurers will be able to assess whether they should be hedging translation risk or disclosing more information to investors. But, fundamentally, the needs of the business should drive the approach that is taken.



Will Hassan **(pictured left) and** Mimi Rushton **(pictured right) are directors in the FX risk management team at Barclays**