CURRENCIES IN FREE FALL

EMERGING-MARKET CURRENCIES ARE DEPRECIATING SHARPLY, A TREND THAT SHOWS LITTLE SIGN OF ABATING. THE PRESSURE IS ON FOR TREASURERS TO PROTECT THEIR COMPANIES' BOTTOM LINE, WRITES FARAH KHALIQUE

The year 2015 has been a tumultuous year for a whole host of currencies – from the benign Swiss franc, which soared in value after the Swiss Central Bank scrapped its three-year cap to the euro – to more exotic currencies, such as the Malaysian ringgit and Thai baht. Emerging-market currencies tend to fall sharply during an economic crisis, which hits the company coffers twice – both in currency and revenues.

Forget BRICS, enter GRC ('grey hair currencies')

The Brazilian real, Russian rouble, Chinese yuan, South African rand and Turkish lira are causing market participants "a lot of grey hairs", says Satu Jaatinen, head of global corporate solutions at Commerzbank.

The Brazilian real has lost almost half its value versus the US dollar since the start of the year, amid deep problems in its economy, while the Russian rouble has weakened as oil prices slide. China's surprise move to devalue the renminbi spurred neighbouring Asian countries to follow suit and weaken their currencies, and rumours of further renminbi devaluation could spark even further falls.

Jaatinen says: "Now there is an adjustment period in the way treasurers look at things. For European companies, the yuan was previously considered a US-dollar exposure because it was pegged to the dollar. Now companies are considering whether it is worth hedging, because interest rates in China are still high."

Jaatinen says that, by contrast, Chinese corporate treasurers are looking at their hedging needs with a more sophisticated approach, especially where markets might be illiquid or have fewer hedging products available.

Keep it simple

Forward contracts are a straightforward way for companies to lock in today's exchange rates for a future currency purchase. Brewer SABMiller, home to a dizzying array of beers, including Peroni and Pilsner, prefers to keep it simple, says treasury manager Tom Gilliam.

SABMiller mostly uses forwards to hedge its transactional exposures, which can arise when importing raw materials from overseas, such as malt, used to brew beer. It has exposures to a number of exotic currencies – the Colombian peso, Peruvian nuevo sol and South African rand, to name a few.

"The way our policy is set up, we layer in FX forwards over the course of up to 18 months. Over that period, we enter into hedges every

month or every other month," says Gilliam.

But hedging emerging-market currencies has its nuances. Local currency markets are not as deep as major currencies like the US dollar, and treasurers have to consider the 'cost of carry', which is determined by interest rates. The cost of a forward can be prohibitive when hedging a currency from a country with comparatively high interest rates, like India.

Cost-conscious treasurers can take a more dynamic approach by trying to foresee and respond to events through a momentum-based hedging programme. This means remaining unhedged most of the time, but taking on hedges or increasing hedging if markets start moving rapidly.

Sanctuary In NDFs

PZ Cussons is the healthcare and consumer goods group behind some of the world's best known brands, such as Imperial Leather, the St Tropez tanning range and Sanctuary Spa skincare products. Perhaps less well known is its white goods brand, Thermocool, popular with Nigeria's growing middle class. The company has a strong presence in Africa, and plans to stay in it for the long haul. Group treasurer Scot Morton had to think on his feet when the company's year end coincided with the inauguration of Nigeria's new president, Muhammadu Buhari, at the end of May. It was uncertain whether Buhari would make a decree to devalue Nigeria's currency, the naira, giving PZ Cussons a dollar exposure.

Morton says: "To ensure we were covered, we took out a non-deliverable forward [NDF]. We started talking about it in April and discussed pricing with four UK banks; it cost us about $300,000. An NDF was the right thing to do."

In the end, the exchange rate didn't move and PZ Cussons had to pay up a small amount, but Morton was glad the company hedged its bets. "We hedged with an NDF for a month to cover any devaluations. We are conscious that in Nigeria there is constant talk of devaluing the currency, so we may need to revisit this."

PZ Cussons has an 'exceptional hedging policy' for emerging-market currencies, but Morton wants to make this more regular. The company's Nigerian business is listed on the Nigerian Stock Exchange; the dividend is payable in naira. Once the dividend is declared, the company is paid in US dollars.

"This is not typically hedged, which means, at group level, we continue to have naira exposure. It is not yet a thought in our senior guys' minds to be a bit crafty and do an NDF; my next goal is to hedge our naira dividend," says Morton.

WHAT DO TREASURY PROFESSIONALS THINK?

"US corporate treasurers are *very* concerned about emerging-market currency volatility."
Tony Carfang, partner at Treasury Strategies

"The key message for treasurers is to illustrate the cost benefits and risks involved [of hedging], and try to spell it out as clearly as possible [to the board]. Do your own analysis to illustrate the average cost of different hedging strategies. Get a lot of real market data to back up what you're talking about, rather than just presenting an idea from the bank."
Tom Gilliam, treasury manager at SABMiller

"Currency appreciation can work in your favour. But you don't want to recommend not hedging because markets might go in your favour – you want to play a straight bat. I say to colleagues: 'I don't know the future sunshine and neither do you; let's just stick to our agreed policy and hedge.'"
Scot Morton, group treasurer at PZ Cussons

"There's evidence that being unhedged is the optimum strategy, since markets tend to overestimate the carry, but that's a challenging argument if someone's demanding why you didn't do something!"
Head of treasury at FTSE-listed British firm

The world of options

Treasurers can feel that hedging is too expensive and sporadically use a forward, only when the situation is really bad, says Jeremy Monnier, global head of FX solutions at Deutsche Bank. "Invariably, it is too late. Timing is always an issue. Treasurers need something that allows them to benefit from nominal currency appreciation, but also protect them from a massive tail scenario," he says.

Sophisticated corporate treasurers can consider using more complex derivative products – options – to hedge their currency exposures. Collars are a good place to start, advises Monnier. A collar only hedges outside a certain band, so if the currency hardly moves, then there is no hedge. But if there is a sudden deprecation, as is wont with emerging-market currencies, the hedge kicks in. On the flip side, if the currency appreciates, then the treasurer is obliged to pay the counterparty an opportunity cost – there is no free lunch in derivatives. For example, a treasurer might only be able to participate in a currency appreciation of up to 1%, but would be protected against a depreciation of more than 2%.

Automatic rolling collars are one possibility as a long-term hedging strategy. Some banks suggest that options offer the best protection on a long-term average, based on historical data.

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