Fit for purpose

RISK POLICIES MUST FLEX IF CORPORATES ARE TO TAKE ACCOUNT OF EXTERNAL INFLUENCES, SUCH AS CURRENCY MOVES, OR INTERNAL ONES, SUCH AS ACQUISITIONS. ANH NGUYEN EXPLAINS

On the morning of 24 June, and the weeks following, we spoke to numerous corporate treasurers, who shared the same concerns: "Is my FX risk strategy still appropriate? What actions should I take in the immediate term to protect my financials from further volatility?"

We experienced similar frantic reactions from the global treasury community the morning after the Swiss National Bank broke the peg to euro, or when negative interest rates became a new normal in the eurozone. These concerns are also further elevated for companies that are undergoing organisational or structural shifts, such as an initial public offering (IPO) or M&A.

Across currencies in the Americas, Asia and Europe, the past year and a half has seen more extreme movements beyond two standard deviations – movements that are greater than 95% of statistically expected outcomes. Treasurers and senior management are prompted by the board to explain what steps they are taking to mitigate currency risk in light of unprecedented volatility. From our experience of working with more than 300 corporates globally, a solid foundation of objectives and constraints is the most important compass to navigate uncharted waters and devise risk management decisions. A holistic assessment across all aspects of risk is then required if corporates are to select optimal strategies. Those will then need periodic reviews and updates, particularly in changing environments.

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Put objectives first

Risk management objectives need to be specific, well defined and understood across all levels of the organisation. For the majority of companies, having a hedging strategy in place allows them to buy time to react to sudden shifts in the market with appropriate business decisions and smooth FX impact on the financials. In an ideal world, if a company had perfect ability to change its business operations, such as immediately raising sales prices or changing suppliers in response to adverse currency impacts, the company would not need to hedge. In reality, depending on the industry and competitive dynamics, few companies are able to pass currency risk up or down the value chain immediately. The timing cushion, within which the company can be insulated from these shocks, determines the length of the company's risk management horizon and expectations.

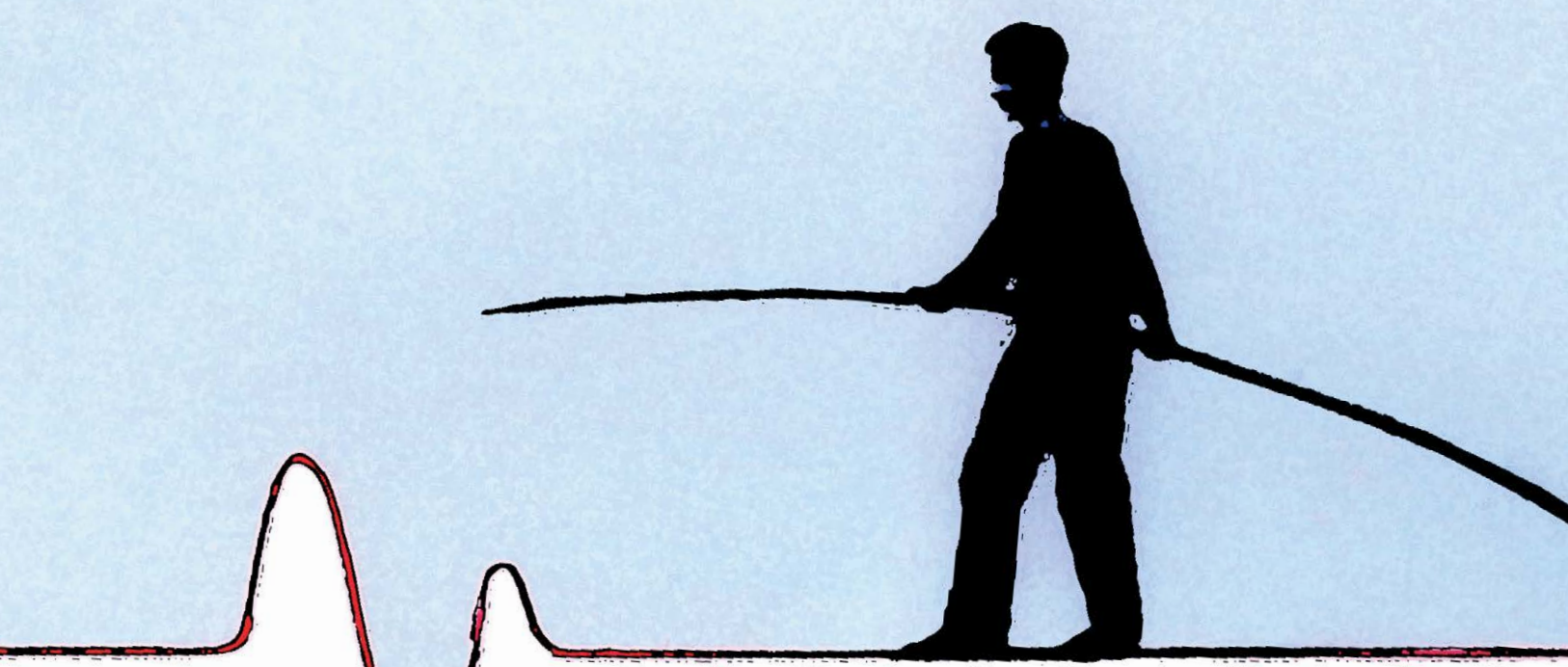
Risk management objectives can change over time as the company experiences organisational shift throughout its life cycle. Impacts on FX risk management approaches due to structural changes in the organisation can be overshadowed by impacts of overnight shifts in external market conditions. While market shocks tend to trigger scrutiny of the company's hedging strategy by the board and investors, more attention should also be paid to how risk management objectives and constraints may change following shifts in corporate structure, such as an IPO or a strategic acquisition.

Such events require the company to reassess its risk tolerance and the sensitivity of its stakeholders. For example, a private company under a single investor's ownership may have a more discretionary view of specific exposures. Once the company is listed, risk management objectives might gravitate towards a removal of financial volatility, given the large base of investors with varying priorities. Similarly, separate entities are likely to have different perception and objectives of risk management that need to be discussed and reconciled upon a merger or acquisition.

Capital structuring and hedging

Strategic capital structure selection can be an effective way to introduce natural offsets to the company's overall risk profile. When used appropriately in conjunction with operational hedging programmes, this approach can provide companies with a more dynamic risk strategy that addresses different objectives and constraints.

An issuance in foreign debt markets (or a synthetic foreign debt via the use of cross-currency swaps) can create a natural hedge: foreign interest payable offsets positive cash flow in that currency on the profit and loss, while the liability itself can be a natural hedge of foreign equity. Operational hedging, on the other hand, is the ongoing hedging of foreign flows generated by the business, to remove volatility in specific financial metrics (for example, EBITDA, net income or covenants). Given the multiple impacts of a single strategy on a company's results, it is crucial that every risk strategy is assessed against specific and well-defined objectives.



For example, a publicly listed company primarily focusing on earnings per share may only reap marginal benefits from foreign debt (via its interest expense netting positive flows in the same currency), whereas a company that cares more deeply about its equity value (for example, to protect investors' equity returns) may consider capital structuring the most efficient tool.

While capital structuring is most appropriate as a longer-term risk-mitigation strategy (for example, three to five years), given the relatively rigid structure of debt, operational hedging can be more dynamic and adaptable to a changing profile of exposures over time. This flexible structure also means that operational programmes are designed to smooth FX impacts over a shorter horizon (for example, a fiscal year), rather than removing risk altogether.

The two approaches, with their respective pros and cons, offer limitless alternatives for designing an optimal policy. They cannot be designed in isolation and need to work in tandem to achieve the level of risk reduction and horizon of risk management defined by the company's objectives. We have seen companies experiencing inefficiencies and unexpected hedging results when capital structuring and operational hedging decisions lie within separate teams, or when there is no holistic assessment of risk profiles across these separate functions. For example, a company may over-hedge its euro net cash flows when hedging forecasted euro EBITDA without taking into account the impact of interest expenses from an existing EUR/GBP cross-currency swap that synthetically converts sterling debt to euro liability.

Policy requires regular review and maintenance

A hedging policy that efficiently addresses the company's objectives, priorities and constraints can be more resilient in the face of changing environments. When confronted with a sudden market shock, the company's approach to natural hedging strategies is less likely to change significantly.

In the shorter term, an operational hedging programme helps insulate the company from this overnight shock, as FX rates are already locked in for the chosen hedging horizon. That said, this benefit is achieved via a sizeable mark-to-market figure, an asset/liability that offsets the FX loss/gain of the underlying exposure to stabilise financial results. A large negative mark-to-market can be emotionally unnerving; in the wake of the EU referendum, we had conversations with companies that considered unwinding their forward contracts to capitalise on the gains, or settle the losses and put on new trades at market levels. These may be discretionary tactics for cash flows and budgeting reasons specific to each company, but might not be straightforward to implement for complex tax and accounting reasons. Moreover, since hedges were put in place to protect certain forecasts against market volatility, there is a strong case for not removing this protection at the most volatile time, unless the nature of the underlying exposures has changed significantly due to this market shock (for example, a re-forecasting is required). In this example, long-term risk management priorities can be overshadowed by foggy market environments, and companies that rely solely on tactical actions may risk no longer having a strategic direction.

In light of recent market shocks, risk management policies should be reviewed to validate whether they are still appropriate and meet set objectives. It should be assessed at what cost these objectives are achieved and whether there are new objectives and constraints that need to be addressed.

With changes in corporate ownership, capital or organisational structure, the company's risk policy should adapt to shifting risk management objectives. Whereas FX used to be a more reactive topic in the larger context of change management in corporate finance and treasury, we have increasingly seen companies taking a more proactive approach to FX discussions at the board and senior management level at the early stage of an IPO, M&A or divestiture in anticipation of shifts in priorities or potential disconnect in objectives and constraints.

In the face of changing environments, we have seen that the three crucial pillars for a resilient risk management strategy are a solid foundation of objectives and constraints, a holistic assessment of potential strategies with both capital structuring and operational hedging approaches, and a discipline of periodic policy reviews and updates.

Anh Nguyen is manager in risk management advisory at Chatham Financial

Chatham Financial