Tat CAPITAL
Corporate Finance & FX Advisory

Impact of FX Volatility and Risk Management Tools for SMEs

Introduction

Given an increasingly globalised world and the fact that we live on an island continent, more and more businesses are importing foreign goods and solutions, using offshore teams and have international customer bases. Inevitably, this means direct and indirect exposures to foreign currency movements. In this note, we take a high level look at FX risk, how it can affect a business, and few risk management tools.

What is FX Risk

FX risk refers to the risk of movements in foreign exchange rates affecting the profitability of a business. This can happen when the revenues and/or expenses of a business are denominated in more than one currency. If not anticipated and managed, FX risk can have a severe impact on the profitability of a business.

FX movements can have a direct, pronounced impact on bottom line, if any of the following are denominated in a currency other than the local currency:

- Imported goods or raw materials
- Outsourced services such as technology or call centres
- Offshore customers and marketing
- International payment gateways
- Equipment and capital expenditures
- Loans and interest payments
- Foreign assets or company holdings
- Distributions to foreign shareholders

While these will be directly affected, movements in currencies can also have indirect impacts. For example, an appreciation in the local currency can reduce domestic growth and income, resulting in reduced consumer demand and a shift to cheaper imports by foreign competitors, even if all incomes and costs are denominated in local currency.

For a smaller business, relying on a few imported, low-margin products denominated in a foreign currency, a depreciation can sometime completely erode an entire profit margin. In the upcoming sections, we will take a look at the effect of domestic currency (assuming the Australian Dollar), appreciations and depreciations, and some tools to manage FX risk.

	AUD appreciation	AUD depreciation
Imported goods or raw materials	Cheaper	More expensive

Outsourced services such as technology or call centres	Cheaper	More expensive
International customer base	Less export competitive, lower revenue	More export competitive, higher revenue
International payment gateways	Lower income	Higher income
Equipment and capital expenditures	Cheaper, lower entry point	Higher CAPEX cost, lower IRR
Loans and interest payments	Cheaper	More expensive
Foreign assets or company holdings	Lower translated value, lower distribution income	Higher translated value, lower distribution income
Distributions to foreign shareholders	Cheaper	More expensive

How to mitigate FX risk?

- Natural hedge
- Hedging through forwards and options
- Diversify sourcing locations and export markets
- Currency risk modelling
- Relationship with an FX broker

Natural hedges are the most effective way of managing FX risk. It refers to the matching of foreign currency receivables with outgoing payments in the same currency. This is most effective when the costs and revenues are incurred at the same time forming a perfect hedge. An example will be to pay 91,500 USD in expenses with 91,500 USD in sales receipts, but the likelihood of this happening simultaneously is low, particularly in smaller businesses. You can make use of natural hedges by maintaining foreign currency balances in foreign currency trust accounts with your FX broker or bank, but this requires careful management of your working capital cycle.

Forwards and options are hedging tools for active management of foreign exchange risk. They can provide certainty of cashflows by locking purchase prices as well as leverage, they also carry complexity and costs that need to be considered and understood. Forwards allow you to lock in upcoming foreign currency costs i.e. buy 50,000 USD to pay for inventory in 1 month's time. As the rate is determined by the interest differentials between the 2 currencies, the forward rate curve is transparent and linear (you should be able to calculate this yourself). This locks in the cost of the USD, giving cashflow certainty and protecting against the downside of a falling AUD. However, you will miss out on gains if the AUD appreciates in the meantime.

If you would like to avoid the opportunity of being locked in through forwards, FX options allow the right to buy foreign currency at determined rate without being locked in. However, these are less transparent, have higher costs through premiums, often only accessible to larger businesses on large volumes, and require a greater understanding of its complexities.

While these hedging tools provide leverage and protect against adverse currency movements, they have limited time spans. The only way to protect against long term pronounced changes in foreign currency is to **diversify product lines and export markets** in different countries (i.e. purchasing from India and China) denominated in alternate currencies (in INR, CNY and USD). For instance, a business relying solely on USD-denominated imports with a 15% profit margin in 2012 when the AUD/USD rate at 1.05 will have a significantly different business model in 2016 when the AUD is 29% weaker.

Currency risk modelling can be simple or complex, but the ultimate objective is to see how the movement in FX rates can affect profitability. If the current AUD/USD rate is 0.75, model on a spreadsheet what your net AUD costs of foreign currency outgoings are at 0.79, 0.77, 0.73, 0.71, 0.69 etc. This will allow you to identify break-even levels for product lines, the overall business, and help build a risk management policy.

We cannot stress the importance of building a relationship with a reliable **FX broker**. They will keep an eye on the FX markets, be a vital part of your overall FX risk management policy in a combination with the above tools, and ultimately allow the freedom to focus on the operations of the business.