The right way to approach Foreign currency Net investment Hedging…

Net investment hedging is an area that is often neglected and misunderstood. Yet ignoring the FX risk in your foreign operations can result in significant losses in shareholder value.

In very simple terms, the value of a foreign business is driven by two elements.

1) The value of the business in foreign currency terms; and

2) the FX risk when translating the business value into your home currency (e.g. Australian dollars).

Any investment manager will tell you that when allocating investment capital to foreign assets, FX risk has to be managed just as importantly as any other risk.

So why is there so much variation in practice when it comes to corporations hedging the FX risk in their foreign interests? The following are some of the reasons why.

Blame the accountants…

Yes, blame the accountants indeed. Because the FX fluctuation in value is recorded in reserves (outside of P&L), there seems to be some false sense of security that there has been no real loss in value, or that it's something you only worry about it when you sell the business. The current executive management may well be long gone by the time that happens!

Shareholders want the FX exposure – right?

I wonder how many shareholders actually know the true exposure to foreign currency. In fact, if the risk profile of the foreign business you own is correlated directly to that country's economy you're probably increasing their risk. That is, if there is an economic slowdown, which in turn reduces the value of the business, the currency is probably also devaluing. NAB lost on both business value AND FX when it eventually sold Clydesdale Bank in the UK. The FX loss alone ran into the billions……

The other point on shareholders is to actually understand who they are. If they are predominantly Australian shareholders, then they will only be interested in Australian dollar returns.

It's a long term investment – FX fluctuations are just swings and roundabouts

A long term investment for who? The company? The shareholders? The current CEO and board? What is long term these days? 3 years? 5 years? 10 years? I hope you get my point. This is a poor excuse when choosing not to manage FX risk results in significant destruction of shareholder value.

So how do I think about managing this risk?

Think about this risk like any other risk. Can you add shareholder value by allowing yourself to be exposed to the FX fluctuation? More directly, can you make money for the shareholder by taking a punt on FX? If the answer is no, then you need to hedge this risk. Think about it. You have taken an Australian shareholders capital, and invested in a foreign business. By choosing NOT to hedge the FX risk in the investment, you are putting a significant amount of that capital at risk. Instead, focus on running a profitable business that returns decent operational returns for shareholders. By not hedging the FX risk in the initial capital invested, you are putting all of that managerial hard work at risk.

How do I hedge the risk?

The most effective way is to hedge using the capital structure. That is, to borrow the funds in the same currency used to purchase the net investment. Derivatives can also be used (such as FX forwards, options and cross currency swaps).

But are there other downsides to hedging?

There are other considerations, particularly for derivatives, but all of them are manageable. Firstly, gains and losses on the hedge may have a different tax treatment to the underlying investment. This can be managed by making appropriate tax elections upfront. Secondly, gains and losses on derivative hedges do generate short term cashflows and therefore liquidity risk. Particularly on the downside, it does cause a cashflow drain, however this can be managed by setting, up front, how much you can bear on losses and then putting in place stop losses on the hedge trades.

Summary

Manage FX risk in your foreign operation investments just like any other risk. If you don't feel confident in adding shareholder value by being exposed to the risk, then you should hedge it. Like with any financial risk management strategy, it should be regularly reviewed as economic conditions and markets change.

Steven Cunico

Partner, Deloitte

Assurance and Advisory

August 2017