

Alternative hedging strategies for companies



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If you are a business that imports or exports, you may be exposed to significant risk due to constant fluctuations in exchange rates. Until recently, you only had two ways to manage your foreign exchange risk:

1) The first has been to wait until you need to make a foreign exchange transaction or payment and take the prevailing (spot) rate. As an importer, you are exposed to a falling exchange rate but you are able to benefit from a rising exchange rate. And the opposite applies for an exporter. This is an 'un-hedged' position.

2) The second has been to fix the exchange rate with a forward contract. This enables you to price into your budget the exact cost of, or income from, the goods you were importing or exporting and protects you from adverse exchange rate moves. However, you are unable to benefit from any subsequent improvement in the rate.

There is now a third alternative: hedging strategies that are tailored to fit your exposure, currency forecast and risk level, that enable you to protect yourself from adverse rate movements and benefit from favourable rate movements. Although these have historically been available to large corporate clients through their banks, we are the first currency broker to offer these to companies in the UK.

Hedging strategies – how do they work?

There are a number of different strategies but generally they work in one of two ways:

1) They enable you to guarantee a worst case rate. This worst case rate will always be inferior to the actual forward contract rate. The difference between these two effectively 'pays' for you to be able to benefit from a favourable move in the rate which can be unlimited.

2) They provide protection by guaranteeing a worst case rate which can be higher or lower than the forward contract rate for which you pay an upfront cost (premium). This is similar to an insurance policy.

What products are available?

Although there are ten strategies that are frequently employed, we have chosen three of the most widely used to describe here: the participating forward, the protection option and the protection tracker. These are illustrated on the next two pages with examples and scenarios.

1) A participating forward for a UK company importing from Europe



ABC Ltd imports from Europe and is due to pay €1m to a supplier in six months' time. The participating forward provides them with a worst case rate to purchase the euros, when they pay the supplier. In addition, it also allows them to 'participate' in any favourable exchange rate move for 50% of the amount ie €500,000.

When they agreed the purchase, the exchange rate was 1.25 and the six month forward contract rate was 1.2350. The company's owner was very worried about the falling exchange rate and didn't want to convert at anything worse than 1.20. However, he was optimistic that it might improve so didn't want to be locked in with a forward contract at 1.2350. He chose a participating forward with the worst case rate set at 1.20.

These are two possible outcomes:

- The exchange rate falls and after six months is trading at 1.10. ABC Ltd can still purchase their euros at 1.20
- The exchange rate rises and after six months is trading at 1.40. They are obliged to buy €500,000 at their worst case rate of 1.20 but can buy the other €500,000 at the prevailing rate at the time of 1.40, giving them an average rate for the whole €1m of 1.30

The benefit of this option is that if the exchange rate rises, the average rate can be better than the forward rate. The disadvantage is that if the rate falls, you would have been better off booking a forward contract. Like a forward contract, there is no premium to pay when entering into a participating forward.

2) A protection option for a UK company exporting to America

DEF Ltd is due to receive \$1m in six months from a sale to a customer in America. The protection option provides them with a guaranteed worst case rate to convert the dollars to pounds when they are paid in six months.

When they agreed the sale the exchange rate was 1.98 and the six month forward contract rate was 1.95. DEF Ltd's finance director felt that the rate might fall further but didn't want it to go back over 2.00 as this would have reduced their profit margin significantly. She bought a protection option at 2.00 for an upfront cost of 1.5% of the notional amount (ie \$15,000 or

£7,600*). This meant that regardless of what happened to the exchange rate over the next six months, if the rate was higher than 2.00 on the pre-agreed date in six months' time, they could convert their dollars into pounds at 2.00.

The obvious downside of this option is that if the rate was not over 2.00 at the time of settlement, they would have paid an unnecessary premium.

*Using a £ / \$ exchange rate of 1.97, effective May 2008

3) A protection tracker for a UK company importing from America



GHI Ltd has agreed to import a shipment from America and has to pay \$1m in six months' time. The exchange rate is good and their accountant wants to ensure it doesn't fall back to the levels of a few years' ago. However, he has read predictions in some newspapers that it could rise significantly over 2.00 and doesn't want to lose out. The exchange rate at the time of purchase is 1.98 and the six month forward contract rate is 1.95.

GHI Ltd chooses a protection tracker. This allows him to set a worst case rate of 1.90 but if the rate is higher than the forward contract rate of 1.95 after six months he gets the prevailing exchange rate less 0.05 (five cents). For example:

| Spot exchange rate after six months | Exchange rate GHI receives at end of six months |
|-------------------------------------|---|
| 1.78 | 1.90 |
| 1.88 | 1.90 |
| 1.93 | 1.90 |
| 1.98 | 1.93 |
| 2.18 | 2.13 |

Please note that this table and any figures and terms cited are for illustrative purposes only.

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For your protection, telephone calls are usually recorded.

The advantage of this option is that GHI Ltd is protected if the rate falls under 1.90 and can benefit if the rate moves higher. The disadvantages are that if the rate in six months' time is between 1.90 and 2.00, GHI Ltd would have been better off booking a forward contract, and if it rises above 2.00, they receive 0.05 less than the prevailing rate. Like a forward contract, there is no premium to pay when entering into a protection tracker.

What can we do for you?

We would be delighted to offer you a no obligation, complimentary review of your foreign exchange exposures and tailor some hedging strategies that may meet your requirements. For an initial chat, please contact your dedicated dealer or call

0800 030 5015 (UK) / +44 20 7801 9050 (Int'l).

Alternatively, please email corporate@worldfirst.com and we will contact you within one hour (during the working week).

If you would like more information on hedging strategies please visit the following page on our website:

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