

Currency Hedging: The Risks and Benefits Aren't Limited to Financial Issues



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When a publicly held company engaged in a multi-billion dollar investment in an overseas location recently, the firm considered using a hedge — or swap — contract to reduce the risk that a big currency swing would impact costs and financial results. The plan was sound financially. Yet, management had concerns about the reaction of investors to this approach and decided to drop the hedging plan, says Chris Rhodes, accounting advisory services partner at PricewaterhouseCoopers (PwC).

Why? Because the CFO determined that, although the hedge would protect all the cash spent in the foreign jurisdiction against currency exposure, the cost of capital — in this case borrowing in external markets — “would be negatively impacted by the inability of some analysts to understand the reporting issues involved,” Rhodes explains. “The concern is that, although many analysts would immediately grasp the sophisticated currency-hedging procedures that were key to the plan, others might not.”

a company’s stock price may suffer even if the hedging actually helps the firm.” So, even though hedging itself is a tool — neither intrinsically good nor bad — “the direct costs and benefits of the strategy have to be weighed against the impact on investor relations.”

Put another way, answering the question “to hedge or not to hedge” is more than a straightforward mathematical decision. “There is no simple answer,” notes [Catherine M. Schrand](#), a Wharton accounting professor. The idea behind currency hedging involves reducing or eliminating risk, but the cost involved and the ability to achieve the aims needs ongoing consideration. “The risks, from political uncertainty, to global funding flows, to the timing of revenue collections and other transactional activity, may be difficult to predict.”

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In this case, at least, the CFO decided she would accept variability in cash costs rather than risk misunderstanding or instability in reported results that could potentially disrupt access to cheap debt financing.

If management makes the right move but doesn’t communicate it properly, the wrong signal may be sent to the marketplace, Rhodes adds. “It may seem counter-intuitive at first, but if analysts and investors don’t understand what the firm’s doing,

An increasing volume of cross-border activity, coupled with rising currency volatility, is forcing many multinational companies (MNCs) to think harder about exchange rate exposure and the way that investors react to the use of currency hedges and other derivatives. For example, a recent press release from the CFA Institute, which oversees the Chartered Financial Analyst designation, notes that derivatives “are prone to leaving investors with a lack of understanding of associated risks and unable to anticipate potential losses if they are not disclosed properly.”

Of course, savvy analysts and investors don't have a problem understanding sophisticated hedging and other strategies, but as hedge-use grows — more than 100 MNCs ranked the risks brought on by currency hedging as their biggest concern, ahead, even, of liquidity risk and counter-party risk, according to a [July 2012 Barclays Bank Plc Global Risk Survey](#) — efforts are being made to ensure that more people have a good grounding in these issues.

Stacking the Costs

Costs can add up quickly, too. "A company will have to hire staff to collect information from subsidiaries and to crunch data, and to maintain relations with a variety of brokers and broker-dealers," Schrand says. "The outlays can quickly become a large fixed cost, so bigger firms are generally more likely to hedge since they can amortize the costs over a larger base."

And not all of the many issues requiring consideration relate directly to the economics of hedging. Another perceived risk, particularly for investors, is incentive asymmetry, or at the least the appearance of it, says Rhodes. "Say you represent a pension fund that's invested in a stock. You want management to have a 20-, 30- or 40-year time horizon, but what if they appear to have a shorter horizon?"

The challenge is that some investors may view the short-term nature of hedge programs as one more example of management's preoccupation with short term results, similar to investors' complaints about managers who obsess over quarterly earnings. But the issue is deeper than that, Rhodes adds, since the short-term nature of budget cycle hedges should be considered in light of how they fit into a company's long-term plan.

Budget-cycle hedging, for example, is useful for managing issues like short-term swings and liquidity that are commonly associated with near-term planning purposes. But what happens when the business design encompasses structural long-term exposures, such as a

revenue base that's tied to the euro but also has funding sources that are in U.S. dollars?

In a case like that, the short-term benefits of the hedge are indeed limited to the maturity of the hedge, but by rolling the hedges, or updating them periodically, management also addresses the long-term exposure issues. That may not be immediately apparent to outsiders, however, so investors will need to understand both the long- and short-term profiles, and how management approaches each.

In fact, Wharton finance professor [Wayne Guay](#) thinks that the potential for a misalignment of managerial vs. shareholder incentives is not as likely now as it once was. In many cases today, most components of management compensation are "stocks and options that vest over a period of years.... Because their portfolio is tied to the long-term stock price of the company, management is more likely to think long-term, aligning their interests with those of investors."

Walking and Talking the Talk

For many companies, the key operational considerations for hedging include why the company is hedging in the first place and how the transactions relate to the core business, Rhodes says. Other prominent issues include the profit margin and credit profile. "Some or all of these issues should be part of the decision-making process. But it really boils down to two elements: How good are you at hedging, and how good are you at explaining it?"

Hedging can be the "hinge" that connects historical cost accounting with fair value concepts, Rhodes says. This idea comes out of accounting regulation ASC 815 (formerly FAS 133), wherein a change in the market value of any derivative — a hedging instrument being but one example — is offset against the change in market value of the underlying asset or liability. Typically, those items are carried on the balance sheet at historical — or acquisition — cost. Changes in the value of the derivative

and underlying instrument then get reported in another section of the financial statements — in the earnings statement. So, while hedging offers economic benefits, it can also complicate score-keeping — or financial reporting — particularly for publicly held companies that must make extensive disclosures.

There's "incredible complexity" when it comes to hedging, says Guay. "Often, there's a tradeoff between a company's efficiency in hedging and the understanding that's communicated to investors. If the hedging tools are so opaque that investors don't understand how the firm works, then it may be better in some cases to back off on the use of complex hedging."

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That "introduces another layer to the discussion, expanding it from a numbers-crunching exercise to an investor relations issue," notes Henri Leveque, leader of PwC's U.S. capital markets and accounting advisory services. "It adds a unique dimension, where a company has to determine if it can overcome the complexity inherent in the hedging instruments as well as the accounting presentation, and if the firm can explain it in a way that outsiders will understand. You have to know your analysts and how they follow certain elements of your company."

Some analysts, for example, tend to make judgments and issue reports based on a narrow selection of metrics that they're comfortable with. He notes, though, that even if the long-term economics and return on equity for a hedge

make great sense, the strait-jacket of financial reporting may jumble the perceptions among some analysts.

"Many of them are able to penetrate the noise and will understand the underlying economics," says Leveque. "But the ones who don't will find it difficult to understand the long-term alignment of the executive suite. So your investor relations professionals must be able to tell a story that lays out the really good analysis that the company did as it navigated a complex financial pathway."

What's more, it is not simply a matter of getting the analyst community to understand long-term, net-positive results. A company may execute "a perfectly good trade with a clear explanation to support it," says Rhodes. But when investors raise questions about the transaction, management may be forced to spend "a significant amount of time" figuring out how to correctly display the activity in the financial statements and how to explain it. Although some companies do this very well, others often "miss the angle" in management's analysis of hedging transactions.

Potential Drag on the Stock Price

How should a company make an overall assessment of a potential hedging transaction? One approach, Rhodes suggests, is to adopt a "four box" decision set — similar to a decision tree — to weigh the pluses and minuses. Imagine a kind of flow chart, where the first "box" poses a "yes" or "no" question that must be answered before moving on to the next box. Each subsequent box also poses a question that must be answered before moving to the subsequent box. The entire process — in this case the decision whether or not to make a hedge — would end if the answer to any question is "no."

"In box one, a company could determine, based on the specific circumstances, whether a hedge makes economic sense," he says. If it does, the company can move to box two, where management should "look at whether, on the

face of it, hedging may drive negative investor reaction.” If decision-makers decide that hedging may make sense after the initial consideration of analyst reaction, then the process moves on to box three, where they may decide that hedging not only can make sense but also the company could either: (1) disregard the level of negative analyst and investor reaction; or, (2) disclose the hedging activity with simplified reporting.

Finally, in box four, the analysis may conclude that hedging may make sense and management may decide to disclose the activity using sophisticated hedge accounting, and that the company will invest the time needed to explain its actions in a way that brings clarity to analysts and investors.

“A best-practice approach will generally call for management to gain a thorough understanding of the underlying issues before making the decision to hedge or not to hedge,” says Leveque. “The four-box decision tree can assist in making that decision, and once management has arrived at a conclusion, it’s a matter of communicating the activity to the investment community. The reason: If analysts or investors don’t understand something, their very human reaction is generally to go negative on it. And going negative is likely to have other real economic impacts on this enterprise that frankly may not have been there.”

To illustrate the practical effect on a company, consider two companies involved solely in gold mining that have taken fundamentally different approaches to earning profits and communicating their business model to the public. One company forgoes hedging gold and the other hedges the commodity.

The first company fundamentally offers a gold price pure-play, says Rhodes. “In effect, management is saying, ‘I control a block of

mineral rights for extracting gold. The value of the gold in the ground will either go up or down and I accept that risk. I focus only on getting it out of the ground efficiently with the right equipment and the right people.’” If gold goes up, the company’s stock will likely go up, and vice versa.

The second mining company chooses to hedge. The message here, says Rhodes, “is basically that when you buy my stock, you are not buying the near-term risk of gold. I hedge against the gold that’s in the ground and the price at which I sell it. The only thing you’re buying is how efficiently I can get it out of the ground.” Investors in the first company buy mostly gold risk “with a little bit of operational risk.” Investors in the second company are “buying mostly operational risk.”

It’s a personal choice. Some investors want a company to retain risk, instead of hedging it out, often because of the potential for a higher return. Others may generally favor the industry’s prospects, but prefer to try to lower the risk of large swings in value. All of this used to be left entirely for investors to sort out. But explaining things in a way that analysts and shareholders will understand is increasingly important because accounting regulations now call for more transparency, notes Schrand.

“Early on, accounting rules regarding the reporting of derivatives actually increased volatility among firms’ reported financial results,” she notes. “That was the exact opposite of what companies hoped to achieve with hedging. But developments like the comprehensive income statement have helped to bring more order to hedge accounting reporting. There is some evidence, however, that the term ‘derivatives’ may cause some concern among investors who associate it with undue risk; so companies should be very careful when they describe their hedging activities.”

In fact improved disclosure is “crucial in allowing investors to make more informed decisions and to ensure that company financial reports communicate key information regarding risk exposures and risk management more clearly,” notes a recent CFA report, [User Perspectives of Financial Instrument Risk Disclosures Under IFRS Volume II - Derivatives and Hedging Activities Disclosures](#).

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Best Practices

When the rewards from hedging appear to be too high to pass up, management could invest the time needed to improve on its explanations of its trades. One potential avenue is through meetings or conference calls with analysts and investors, suggests Wharton accounting professor [Brian Bushee](#).

“It would be best to do it at a time separate from regular earnings announcements or other disclosures, so that everyone can focus on the issue and not have it be confounded with

performance numbers or forecasts.” The only downside would be “potential proprietary costs if this is an open meeting, such as a freely available conference call or webcast” where “competitors could potentially listen in and gain competitive information. So perhaps a better venue would be an investor conference, or even a private meeting.”

Private meetings are not necessarily forbidden by Regulation FD (Regulation Fair Disclosure). “As long as the managers of a publicly held company do not give out earnings or sales guidance, and just stick to the details of the hedging strategy, then there would be no problem with a private meeting,” Bushee says. “This is because the managers are not disclosing privileged information, but are simply filling in the ‘mosaic’ of analyst and investor information.”

Some clear lessons in all of this are that decisions about currency hedging are highly case-specific and will vary depending on a company’s individual circumstances. But on balance, hedging is very complex. “Decision makers must talk to the CFO, the CEO and the board, and explain the economics,” Rhodes says. It also takes a material amount of time to know how to “correctly display and explain their strategy” to analysts. An integral part of that: “You must know your analysts, and how are they following” complex derivative transactions.

To have a deeper conversation about how this subject may affect your business, please contact:

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