Euro Pain

As the euro plummets and the dollar soars, U.S. exporters and multinationals try to limit the damage to revenues and earnings.

Edward Teach

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Down, down, down. One dollar thirty-nine cents, $1.29, $1.19, $1.13. From the beginning of May 2014 to the end of January, the value of the euro fell a stunning 19% against the U.S. dollar. It paused briefly, and then plunged to $1.05 in March, the lowest level since 2003. Many analysts see parity with the dollar ahead, if not lower.

No wonder many CFOs are having that sinking feeling. As the dollar gathered strength against the euro and other major currencies in the second half of 2014, weakness surfaced in the earnings reports of U.S. companies doing business abroad. About two-thirds of exporters with at least 25% of their total sales overseas reported a negative impact from the strong dollar, according to a new Duke University/CFO Magazine Global Business Outlook Survey. “We are in the midst of an ugly contest to see whether the euro zone, Japan, or Canada can depreciate the most against the U.S. dollar,

For the fourth quarter alone, North American companies reported total currency impacts of $18.66 billion, according to a report by Fireapps, a currency risk management consulting firm. The report
examined the results of 846 publicly traded companies. “Set against the fact that the dollar has risen 8% against the euro in the first two months of 2015 alone, it appears that worse impacts may be yet to come,” the report warned.

As a result, companies are looking for ways to assuage the pain. Many are reexamining their foreign exchange hedging programs — or revisiting their decision not to hedge forex risk at all. Others are seeking relief by raising prices, renegotiating contract terms, or setting natural hedges.

**Casualty List**

The slide of major currencies against the dollar has spared few U.S. exporters and multinationals. Here is a sampling from the casualty list:

- The appreciating dollar accounted for 3% of Hewlett-Packard’s 5% year-over-year decline in first-quarter revenue, CEO Meg Whitman said in February. The technology giant derives 65% of its revenues from outside the U.S., and more than half of that from Europe, the Middle East, and Africa (EMEA). HP now expects foreign exchange to reduce its sales growth rate for fiscal 2015 by six percentage points, or $3.3 billion more than it estimated in October. “We are working hard to offset these impacts through repricing and productivity,” said Whitman.

- At Discovery Communications, changes in currency rates reduced revenue by $100 million in 2014, CFO Andrew Warren said in February. The pay-TV giant generates over half its revenues outside the United States, including an anticipated 30% in the euro zone in 2015. At current spot rates, foreign exchange will reduce Discovery’s 2015 results by $350 million, or 6%, Warren said.

- The euro wasn’t the only currency causing forex pain. Sabrina Simmons, CFO of The Gap, noted in February that the clothing retailer’s largest foreign subsidiaries are in Japan and Canada, whose currencies have depreciated by 30% over the past two years, she said. Simmons estimated that foreign exchange will trim The Gap’s EPS growth rate by about 6 percentage points in 2015, equal to more than $100 million of pretax earnings.

- At Procter & Gamble, currency devaluations, including a 53% drop in the ruble, shaved 5 percentage points off the company’s sales in its fiscal second quarter, CFO Jon Moeller said in January. For the year ending in June, P&G forecasts that foreign exchange will reduce its profits by $1.4 billion, of which $1 billion will be due to currency exposures in six countries: Russia, Ukraine,
Venezuela, Argentina, Japan, and Switzerland.

- Strong currency headwinds caught smaller companies off-guard, too. 3D Systems, a $230 million maker of 3D printers, saw forex reduce revenues by $6 million during the fourth quarter. “We certainly did not foresee the sharp decline in foreign currencies that happened towards the tail end of the year,” said CEO Abraham Reichental in February. “And as we look in particularly at Europe at the moment, we see those headwinds continuing well into the second half of this year.”

**The Dollar Gathers Strength**

Although the speed of the decline came as a surprise, many market watchers had anticipated both the euro’s fall and the dollar’s rise, noting the differing growth rates and diverging monetary policies of the euro zone and the U.S. The dollar began to gather strength in 2014, thanks to back-to-back quarters of robust economic growth, and to the Federal Reserve Board’s decision in October to end quantitative easing. Meanwhile, the euro zone registered barely positive growth, prodding the European Central Bank to cut interest rates and take other measures to stimulate the economy.

“[The euro zone’s] monetary policy had been much less aggressive, for fairly understandable reasons,” says Patrick O’Keefe, director of economic research at Cohn Reznick. Germany’s views carry exceptional weight, given that the country is the currency area’s largest and strongest economy, and the memory of the Weimar Republic’s hyperinflation is “seared on the consciousness” of the Bundesbank, O’Keefe says. As a result, Germany’s preference for monetary conservatism ruled after the recession ended.

Until recently, that is. In November, ECB president Mario Draghi hinted that quantitative easing was in the cards. Then, on January 22, the ECB announced it would commence a $1.1 trillion round of QE, starting in March and continuing until September 2016. The euro fell 2% against the dollar the next day. Meanwhile, in the U.S., the Fed continued to signal that it would raise interest rates in 2015, possibly as early as June, thus accelerating the dollar’s rise — and perhaps the heartbeats of some CFOs.

**Panic Mode**

Two years ago, when the dollar’s volatility was low, a survey of 1,075 companies by Chatham Financial found that 76% had forex exposure, but only 48% hedged the risk with financial
instruments. Today, the phones are ringing more frequently at forex consultancies like Chatham.

“We’re getting a lot of calls,” says Amol Dhargalkar, managing director at Chatham. “Some of them are in a bit of a panic mode. Boards of directors have been asking CFOs and treasurers what their [forex] policy is, what their hedging program is, how to stop the bleeding.”

Many companies have shunned hedging because “they take a long-term view: the dollar’s going to rise and going to fall, and we’ll win in some years, and lose in others — it’ll all come out in the wash,” observes Mark Frey, chief market strategist at Cambridge Mercantile Group, a provider of currency-hedging services to companies. But even those companies are rethinking forex hedging in the wake of the euro’s rapid decline, he says.

“If you are a large multinational, you should be able to access credit and trading facilities to efficiently hedge your risk yourself.”

— Mark Frey, chief market strategist at Cambridge Mercantile Group

Some of Cambridge’s corporate customers that sell in euros are raising their prices, rather than absorb the currency’s decline against their operating margin — “in many cases they can’t, because the margin isn’t large enough,” Frey says. Doing so, however, makes their products less competitive. Others are holding the line on pricing, hoping to acquire market share and retain their new customers when they eventually do adjust their prices.

Other companies are renegotiating customer contracts, which Frey calls “a painful exercise.” They are adding provisions for renegotiating terms based on exchange-rate volatility, “so if the currency moves more than 10%, they have some availability to come back and adjust pricing,” Frey says. In effect, they are offloading the forex risk to their customers, “making it more expensive for them to do business with you,” he says.

“If you are a large multinational, you should be able to access credit and trading facilities to efficiently hedge your risk yourself,” Frey says.

“We Can’t Do Magic”

Hedging isn’t a magic bullet, nor do many multinationals hedge all of their currency exposure. In January, IBM finance chief Martin Schroeter reported a currency impact of $1.2 billion on the company’s fourth-quarter revenue, which totaled $24.1 billion ($8 billion came from the EMEA region). “We hedge a portion of our cross-border cash flows, which defers the impact of the currency movement, but it doesn’t eliminate it,” Schroeter noted in his prepared remarks. “Our hedges are designed to provide stability around the receipt of cash, but there is no year-to-year benefit in the income statement when a currency’s direction is sustained over a longer period.”

That is a concise summary of the limitations of forex hedging. “Hedging doesn’t mean that you won’t ever experience an adverse currency-rate environment,” comments Helen Kane, president of Hedge Trackers, a forex consulting and software company. A hedging program, she says, “is all about providing visibility for management into what value a currency will have — the euro, the yen, the pound — when it comes into your financial statements.”
Kane says her firm is “fielding calls almost daily from companies with a new interest in hedging.” What does she tell them? “I like to start off with a discussion of what hedging can and cannot do,” she says. “We can't do magic with a hedge program. I tell them we can help them lock in currency rates or set a floor for where rates are now.” Right now, buying options to set a floor for the euro or the yen is expensive, Kane warns. “It’s kind of like insuring a teenage driver. It’s not cheap — and for good reason.”

Some companies are wary of the work involved in setting up a hedge program (see “Forex Hedging in Five Steps, below). Others balk at the complexity of hedge accounting, which they must adopt in order to reduce the earnings volatility resulting from repeatedly measuring a forex option, say, at fair value. But that shouldn’t be an obstacle, says Kane, who is deeply versed in the relevant accounting standard, ASC 815. Hedge accounting is complex, she agrees, “but corporate accounting organizations are doing a lot of complex accounting these days.”

Most companies hedge forex risk up to a year out, Kane says, although some may hedge as long as five years out. “We would be expecting companies to show a substantial amount of protection from last year’s hedges in the first quarter of this year, then fading off the rest of the year,” she says.

Indeed, Kane says now is “a great time” for companies that are cost-based in Europe and hedging the euro. “They might have locked in forward contracts at higher rates last year, so they’re losing money on those, but now they’re locking in contracts at what for them is an attractive rate,” she explains. “Their costs in the future are going to be lower, and they have time now to prepare for that improved margin.”

**The Outlook Ahead**

Today, the economic outlook for the euro zone is slowly improving. In March the ECB raised its forecast of GDP growth in 2015 to 1.5%, a modest but welcome improvement over last year’s 0.9% growth for the currency area.

The recent fall in oil prices will add a tailwind to the economy, says Richard Boxshall, senior economist at PwC in London. Boxshall offers a country-by-country rundown: “We expect Spain to grow the fastest since 2007,” he says. “Portugal should grow quicker than at any time since 2010.” Germany will remain relatively strong, but France and Italy, which account for about 37% of the euro zone economy, “will continue to bobble along the bottom” with near-zero growth, Boxshall says. Greece, which entered 2015 with a shrinking economy, “is going to have a tough year, irrespective of what happens with its position in the euro zone,” but it only constitutes 2% of the euro zone’s economy, Boxshall points out.

As for the value of the euro against the dollar in 2015, estimates range widely, with many analysts predicting parity or lower. But Ludovic Subran, chief economist and director for economic research at trade credit insurer Euler Hermes, isn’t one of them.

“I have trouble thinking the euro could go to parity or below,” Subran says. “If it does, it won’t be
there for the long run.” As the weak euro boosts the euro zone’s exports and QE stimulates the economy, the currency should strengthen somewhat in the second half of 2015, he says. Euler Hermes’ forecast for the value of the euro at the end of the year is $1.10. (Subran says the long-term equilibrium exchange rate should be $1.15.)

A possible rise in the euro shouldn’t deter companies from hedging, says Kane. “Some people are thinking, I’m not going to hedge now, because the euro is already back to $1.08. That would suggest they knew where the euro is going next. Given that most of us don’t know, if you put a hedge program in place, you’ll know the U.S. dollar value of those future euro flows.”

“Hedging buys certainty and time,” says Chatham’s Dhargalkar. Over time, as companies grow larger, they can take advantage of natural hedging, by not only selling but also sourcing in Europe, so they can match revenue and expenses in the same currency. Some companies are accomplishing this by issuing euro-denominated debt, as Coca-Cola did in February, selling a record $9.5 billion in bonds at rock-bottom euro zone interest rates.

But companies issuing euro-denominated debt should make sure they match their obligations with forecasted sales, Cambridge’s Frey warns. “If you’re taking a long-term view, it’s reasonable to assume that the euro would materially improve — say, by 15%—over the next 5 to 10 years,” Frey explains. “If you’re borrowing in euros and don’t have sufficient capital inflows later on to offset that risk, your euro obligations in dollar terms may increase significantly.”

*Edward Teach is editor-in-chief of CFO.*

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**Tools of the Trade**

*Common forex hedging instruments*

- **Forward contracts** fix an exchange rate on a stated amount of currency for delivery within a defined time frame. Forward contracts are used in circumstances where two currencies must be exchanged at a date in the future. Closed forward contracts must be settled at an exact date. Open forward contracts set a window of time within which any portion of the contract can be settled, as long as the full amount is settled by the expiry date.

- **Vanilla options** are financial contracts giving businesses the right, but not the obligation, to buy or sell a stated amount of a currency at a predefined price over a certain period of time. Due to this optionality, vanilla options carry a substantial initial cost and are therefore typically used to hedge only under extremely specific circumstances.

- **Structured options** are contracts that simultaneously use a combination of vanilla options and other special features to create a customized hedging instrument designed to fit a particular situation or capitalize upon a potential market outcome.

- **Foreign exchange swaps** are contracts wherein one currency is sold against another at inception,
with a commitment to reexchange the principal amount at the maturity of the deal in order to deploy cash resources as efficiently as possible. These swaps are structured as spot trades combined with offsetting future-dated forward contracts, so that net foreign exchange exposure is removed and funds are positioned where needed.

- **Nondeliverable options and forwards** fix the exchange rate for a defined future date, when delivery of a foreign currency does not occur. Instead, counterparties settle the difference between the contracted rate and the spot price at expiry in domestic currency. Nondeliverable instruments are used to protect against exchange rate movement in markets like India and Brazil where onshore delivery is virtually impossible. They are also used where there is an underlying commercial exposure but no delivery of foreign currency is required, such as when a business seeks to mitigate the translated balance sheet impact associated with an operating unit in a foreign jurisdiction.

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**At Polycom, No Surprises**

One company that hedges against the euro is Polycom, a leading maker of video and audio solutions for business collaboration. Although most of the company’s international sales are denominated in U.S. dollars, portions of sales in the euro zone and the U.K. are denominated in euros and British pounds, respectively. (Europe, the Middle East, and Africa accounted for 26% of Polycom’s $1.35 billion in revenue in 2014.)

Polycom hedges its exposure for Europe and other parts of the world with two programs. One is a cash flow program, which hedges anticipated revenues and operating expenses. “Euro revenue is our largest exposure on the cash flow side,” says Walt Boileau, vice president and corporate treasurer. “We hedge it on a rolling four-quarter basis. We buy euro forwards to provide us with an exchange rate that we can rely on, assuming our forecasts are reasonable.” The cash flow hedges go out no farther than 13 months, he says.
The point of the cash flow hedges is to provide visibility and predictability, Boileau stresses. “They allow us to know what our USD equivalent of euro revenue will be at some future date,” he says. “Keep in mind, hedging doesn’t eliminate foreign exchange risk. As we roll our hedges, we’re resetting our forward contracts to market rates.” The program also enables the company to set its annual foreign exchange budget rate “with a decent degree of confidence,” Boileau says.

The other hedging program is for the balance sheet, to minimize the impact of currency fluctuations on the remeasurement of the balance sheet accounts that are reflected in the Other Income and Expense section of the income statement. “We try to hedge a majority of the balance sheet exposure, factoring in, among other things, the materiality of the exposures,” Boileau says. Again, the hedging tool of choice is simple forward contracts, typically maturing in one month.

Each quarter, Boileau, CFO Laura Durr, and other senior finance leaders review the strategy of the hedging program and its results for the previous quarter, using the company’s foreign exchange policy as their guide. The policy sets criteria for deciding whether an exposure can be hedged, including the need to consider the hedging cost of the currency involved, the materiality of the exposure, the ability to forecast exposures with confidence, and so on. (Polycom also hedges its exposure to the Chinese yuan, Japanese yen, Brazilian real, Mexican peso, and Israeli shekel.)

Durr also periodically reviews the hedging program to check its compliance with the internal control requirements of Sarbanes-Oxley. Overall, “the point of the regular review is to make sure that treasury isn’t acting in a vacuum,” Boileau says.

Polycom will consider natural hedging before it places any synthetic hedges, Boileau notes. “For example, there may be situations where there is potentially too much cash in a local currency.” Managing that cash down to the minimum amount needed can reduce both the size of the exposure and the cost of hedging it with forwards.

One sign of the hedging program’s effectiveness: There were no forex surprises warranting comment in Polycom’s most recent quarterly earnings call. —E.T.

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**Forex Hedging in Five Steps**
Generally, consultants recommend the same basic sequence for launching a foreign exchange hedging program. Here is Cambridge Mercantile Group’s five-step process:

1) Identify and evaluate your exposures, whether in cash flow or on the balance sheet. This can be a difficult exercise for large firms that operate in multiple jurisdictions or have multiple ERP systems. “Try to determine where you have internal netting opportunities for natural hedging, and arrive at an overall net exposure,” says Mark Frey, chief market strategist at Cambridge.

2) Quantify the potential risk on those exposures to determine their materiality. Common methods use the volatility of a currency over the past 12 months or its implied volatility, Frey says, but “the simplest way to do it is the ‘smell-test’: If a potential loss is big enough that you have to mention it on an earnings call, you should be doing something to manage the risk.”

3) Set an internal budget rate for pricing the currency within your financial forecasting model, and make sure it is accepted and understood throughout the business. “It has to become the number you target for execution of your hedges going forward,” Frey says.

4) Develop and implement the hedging strategy. Executing trades, placing orders to layer in a series of hedges over time — “This is the easy part,” Frey says.

5) Reevaluate your hedging strategy at least annually, if not every 6 months, to make sure it still aligns with the overall business. “If you’re executing a series of hedges but sales is still dynamically pricing contracts to customers based on current market levels, you’re not getting the full benefit of your strategy,” Frey says.

Says Chatham Financial managing director Amol Dhargalkar: “The fastest we’ve seen someone go through this process — from saying “Let’s do this” to putting in their first set of hedges in place — was a month.” That was a privately held, multibillion-dollar company, he says, that could make decisions and bring in the necessary resources more quickly than a public company could.

Smaller companies can move even faster. Last fall, one of Hedge Tracker’s clients launched a program in just two days, says president Helen Kane — “They called, they needed to go, they had good data, good banking relationships.” But generally it will take a month to two months for companies to jump through all the hoops necessary to set up a program, she says. —E.T.

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