Financial risk management for SMEs dealing internationally

Navigating foreign exchange challenges

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FX risk management forces leadership teams to consider worst-case scenarios when managing budgets, cash flow and profits. This guide is designed to help businesses consider areas where their bottom line may be exposed and methods to reduce these risks.

Organisations of all shapes and sizes deal with fluctuations in their finances. When a business is in a growth period, risk management may slip down the priority order due to increased profits and investment. However, if times become tough, reacting quickly and getting sufficient risk mitigation in place can be difficult.

For businesses that trade internationally, there are a multitude of factors, many out of their control, which can result in unexpected financial loss.

For SMEs, these risk factors represent a particularly significant challenge as these businesses are more likely to be impacted by increased costs and damage to profit margins. This requires SMEs to ensure they have a handle on their FX risk exposure, which this document aims to support and provide a basis for.

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STEP 1

Determining risk exposure and tolerance

While there is a key focus on FX risk and protecting profits against fluctuating exchange rates, recognising where your risk exposure lies can be challenging.

It is crucial that risks are recognised early and the potential business impact is understood. Risk mitigation solutions can then be implemented while in a position of strength.

It is also important for businesses to determine their level of tolerance when it comes to risk. This is much more subjective and requires teams to determine the amount of risk they can afford and how this compares with the potential benefit.

"Risk mitigation solutions can then be implemented while in a position of strength."

All elements of business have a certain level of risk but using that to a competitive advantage either through an investment, new product development, or mitigating the risk of exchange rate fluctuations is possible.

When is your business at risk from fluctuations in exchange rates? If you deal in multiple currencies, use international suppliers and buy and sell in overseas markets, you are at risk the majority of the time.

How to determine which areas of the business are most at risk varies from business to business, but there are fundamental questions finance teams should be asking.

Which currency pairs are being traded?

Questions such as these will get you closer to understanding where risks lie. For example, an overview of which currencies you are most reliant on may unveil vulnerabilities. While any currency pair can be affected by sudden movements, it may be that 90% of your business is done in Euros and mainly traded with the Pound. Naturally, your vulnerability lies in the EUR/GBP pair, as it is responsible for most of your costs and profits.

However, while this can be used as a starting point, there is much more to consider than just the amount of business going through one particular currency. Some currencies have been considered safer than others, such as the US dollar, Norwegian krone and Singapore dollar.

While on the other side, certain currency pairs are more volatile, like GBP/AUD, AUD/USD and CAD/JPY. These more volatile currencies should be considered a greater risk however the last few years have highlighted how most currencies are subject to movement and while some market influences such as interest rate increases are more foreseeable, other like geopolitical challenges as less predictable. When considering significant shifts in exchange rates, it is important to identify opportunities as well as risks. An example of this can be seen following the UK Brexit referendum.

The decision to leave the EU resulted in the GBPEUR exchange rate dropping heavily. While this was bad for importers it created more opportunity for exporters.

How much of a buffer is there in your profit margin?

Profits are ever-changing and differ across customers, regions, products and more. Once a business has an expected profit margin, the last thing needed is exchange rate movements wiping it out.

Naturally, businesses with narrow profit margins have a greater requirement to have adequate risk management and budgeting in place.

Currency swings of one or two percent are not uncommon and could be the difference between making a profit, breaking even, or suffering losses. Businesses with a larger buffer when it comes to profit margins also need to ensure protection is in place, not only to ensure larger profits are locked in, but also to provide protection should profit margins need to shrink to maintain customers and remain competitive.

What lead times exist in the manufacturing or delivery process?

The most basic form of FX risk occurs when the exchange rate changes during the time between a business transaction being confirmed and the payment for the product or service being settled. The amount of risk involved depends on the transaction's size and the time between the transaction and the payment being settled.

The more time between these two, the greater the chance of significant movement in the market. While this is true, exchange rates can soar or fall unexpectedly and significantly in no time at all, something we have seen over the last 12 months, particularly with uncertainty across financial markets. The impact of this on the business' bottom line can be magnified particularly as it is more difficult to control fixed costs in short term.

If a business does have extended lead times on products or materials, their exposure may be greater. Certain industries are more susceptible to long lead times, such as the food and agriculture sector, or those sensitive to supply chain delays. There are also scenarios where organisations may want to have contingency plans in place, such as when bidding on tenders. Flexible foreign exchange solutions are required here as those bidding do not want to be trapped in an FX agreement should they be unsuccessful in their bid but more importantly not have any exchange rates locked in on the event that they are successful.

Even if you do not perceive that your business deals with especially long lead times, a matter of weeks between agreeing on a cost and settling the invoice can lead to sharp market movements and increased costs.

Once SMEs have determined where their risk exposure exists, they will need to factor this into yearly budgets, ensuring that sensible exchange rates are included to work out potential profits and costs.

STEP 2

Budget considerations

Businesses that know their outbound (or inbound) foreign exchange requirements will need to include this as part of their budgeting process. This can be difficult as although they may understand how much currency they require over 12 months, they do not know how their required currency pair will move during that time.

> “Once a budget rate is in place, it is crucial that teams across the organisation are aware of and adhere to it.”

As a result, determining an appropriate exchange rate to include in your budget can be difficult and result in potential losses if miscalculated. If a business only has fixed costs in a foreign currency, setting a rate as part of a budget is much easier.

For some businesses that have variable costs, the rate included in the budget is that much more important. When budgeting for the next year or few years, a business can estimate the foreign exchange rates to set their budgets and estimate their profitability based on these, which will also feed into how they determine their prices for goods or services.

For example, a film production company based in the United Kingdom may need to pay for equipment rental and services in the United States. The GBPUSD rate will likely differ when budgeting for the production to when the film crew are on location. If the exchange rate between pounds and dollars is more unfavourable at this time, a rise in production costs can lead to a squeeze of budgets and profits overall.

Due to the lengthy timescales in industries such as film and TV, the business may need to choose a budget rate to estimate costs for one or two years. Estimated budgets can, of course, be changed should the rate move unexpectedly, but an unrealistic exchange rate used at the start of the project can lead to financial difficulties and increased costs later down the line.

We understand that each business is likely to already have its own tried and tested process when selecting a rate to include in a budget, often factoring in forecasts, the current rate, and trends over previous years. Currencies Direct can support SMEs with how best to approach this process and offer expertise when it comes to creating your budget.

Once a budget rate is in place, it is crucial that teams across the organisation are aware of and adhere to it. The next phase is to add risk mitigation tools to ensure that you are covered alongside your budgeted rate should your desired currency weaken.

STEP 3

Protection against volatility

More and more SMEs are locking in profits and protecting cash flows as businesses seek confidence in a time of frequent market volatility.

Exchange rate volatility can be sudden and significant. An exporter, for example, experiencing a surge in their domestic currency faces an unappealing choice: reduce prices to remain competitive with local suppliers or accept lower profit margins when funds are converted back to the home currency.

Due to the current economic landscape, the risks of adverse market movement are increasingly prevalent. As a result, a greater focus should be placed on mitigating risk. However, this does not mean opportunity within such volatile markets cannot be sought.

The need to balance protection with opportunity represents a significant shift from businesses seeking appropriate exchange rate risk management strategies ('hedging').

Effective risk management (minimising rising costs from a change in the price of one currency against another) seeks to transform risk into an acceptable form. It is not only the world's largest corporates using derivatives to manage their exposure, but hedging is also something SMEs can utilise. As international payments continue to evolve, more businesses seek innovative hedging solutions to protect their margins and explore a competitive advantage.

Tools to hedge FX risk

Forward contracts

Forward contracts are simple non-standardised agreements to exchange two designated currencies at a predetermined exchange rate on a specific future date. Highly effective at protecting against adverse market movement, Forward contracts remove the likelihood of nasty surprises by allowing businesses to lock in an exchange rate for later use. This gives finance teams much greater certainty when managing funds and payments in multiple currencies.

FX Options

Options are versatile financial products commonly used by commercial entities to reduce exposure to exchange rate risk. Using Options as part of a comprehensive foreign exchange risk management strategy can provide the protection, flexibility, and opportunity required to fulfil unique risk and reward and/or cost and benefit objectives.

The ultimate objective is risk mitigation, although there are strategies available that enable businesses to pursue both objectives simultaneously. Currencies Direct Financial Markets Ltd, part of the Currencies Direct Group, possesses the capability and licensing to offer a specialised range of FX Options.

These products come with varying levels of risk, providing options for managing foreign exchange exposure alongside opportunities for upside gains.

Important information

FX Options can carry a high level of risk and may not be appropriate and/or suitable for everyone. Transacting in FX Options can result in losses that exceed costs and/or deposits. Please take all reasonable steps to ensure that you fully understand these products and the risks associated with them before proceeding with any transaction involving FX Options. Currencies Direct Financial Markets Limited is authorised and regulated by the Financial Conduct Authority for the conduct of designated investment business and the provision of payment services. FRN: 495699.

Three common strategies to hedge FX risk

1. A fixed strategy that aims to provide specific protection needed up to a particular point in the future. Referred to as a static hedge, it is not adjusted once implemented. It is usually fixed at the end or beginning of one financial year to protect the anticipated exposure upfront.

2. A rolling hedge, which forecasts short-term exposure only and hedges this on a rolling basis – i.e., repeating a process frequently to cover cashflow requirements.

3. A layered or 'portfolio' strategy whereby a longer-term view is taken and hedging decisions aim to reduce exposure over a 6, 12 or 18-month period, ensuring that specific exposure percentages at each tenor are adequately covered. This approach is most dynamic and functional as it reduces vulnerability to short-term risk trends and often obtains a smoothed average exchange rate over the long term.

An effective risk management strategy transforms risk into an acceptable form: protecting the business rather than seeking to profit from favourable market movement. This does not mean that your market view needs to be discounted or not factored with appropriately weighted consideration, but ensuring risk is effectively managed should be the priority.

STEP 4

Implementing your strategy

Businesses that have FX exposure should consider a formal risk management strategy. Not having an FX strategy in place leaves businesses unprepared for volatile currency movements, resulting in unexpected costs, lower profit margins and limits to cash flow. Comprehensive risk management considers exchange rates your company may face now and in the future.

While implementing a risk management strategy may come with an upfront cost, such as a deposit on a forward contract, it provides businesses with stability when dealing internationally.

With the unpredictable nature of the foreign exchange market, the potential cost of a weakening exchange rate has no limit. Knowing when to implement your strategy can be difficult, as active orders, invoices and agreements may lead leadership teams to delay implementation.

While there may be more favourable times to implement new processes, such as the end of a large project or the start of a new fiscal year, the sooner you have effective FX risk management in place, the better.

Utilising support in this area can be extremely valuable. Having a foreign exchange broker by your side will enable you to understand all available options when integrating new international payment procedures into your day-to-day operations.

STEP 5

Measuring success

It is imperative for any business looking to mitigate FX risks to establish a formalised risk management strategy that is regularly updated. External risks such as economic and geographical factors need to be frequently evaluated and to ensure your chosen method remains optimal.

This approach empowers businesses to make strategic hedging decisions, providing a sense of security that allows teams to concentrate on the core business.

Benchmarking plays a pivotal role in confirming that your strategy effectively mitigates risk.

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It is essential to avoid misconceptions that a hedge is unsuccessful solely because the exchange rate moves further in your favour, potentially resulting in a less favourable rate being locked in.

Strategies such as early drawdowns or partial currency hedging for the year can be explored to address this issue. Even if the rate becomes more favourable, the hedge can still be considered a success if profits have been protected. When setting benchmarks for success, it is crucial to maintain a realistic focus that primarily measures protection rather than fixating on opportunity.

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Get in touch with our in-house experts for a free consultation on how you can protect your budgeted exchange rates and cashflows.

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