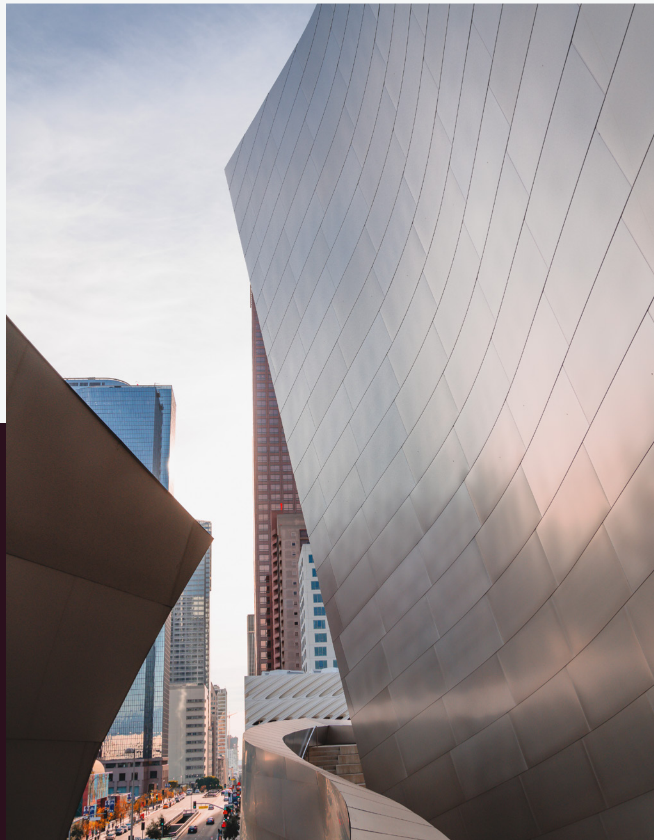
Dispelling the Top Four Myths of Foreign Exchange Risk Management



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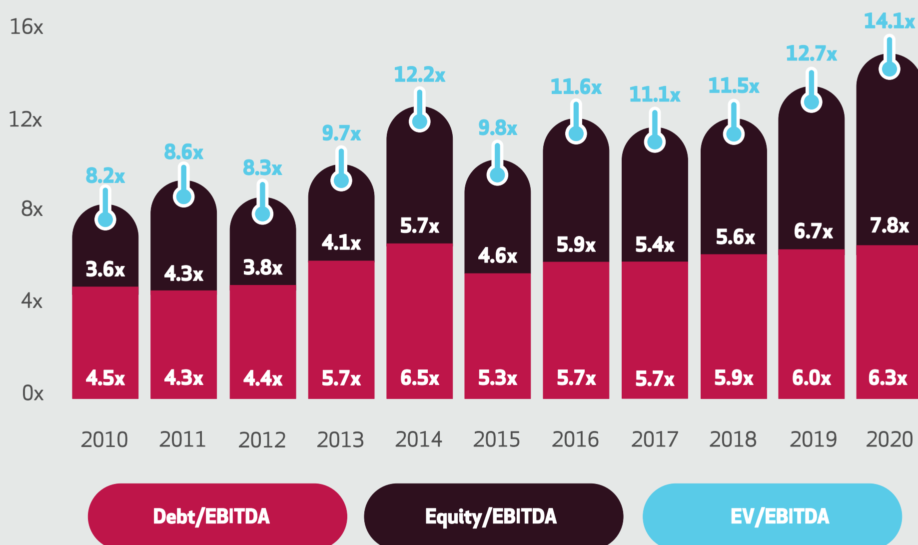
Dispelling the Top Four Myths of Foreign Exchange Risk Management

Red hot markets, the proliferation of Special Purpose Acquisition Companies (SPACs) and exceptionally loose financial conditions have driven ever greater competition amongst deal makers. This competition has sustained deal flow and acquisition multiples while also making creative deal-making more accessible.

In fact, despite the disruption wrought by the coronavirus pandemic, 2020 was one for the record books. Despite this, ultra-low rates and accommodative credit markets have become somewhat of a double-edged sword. While facilitating deal making, the growing preponderance of debt in both acquisitions and corporate capital structures also introduces elevated risk should there be an extended period of economic malaise.

Median Buyout Multiple



Source: PitchBook | Geography: US

Fortunately for funds and portfolio companies with international exposure, there are powerful but often neglected strategies to enhance working capital management and reduce cash flow risk. These enhancements can, in turn, improve business and fund valuations.

Prominent amongst these strategies is FX hedging which research has demonstrated can often add shareholder value when implemented appropriately. That said, there are common misconceptions around the nature of FX risk and FX hedging that frequently lead to missed opportunities to enhance value. It is the goal of this article to dispel these myths.

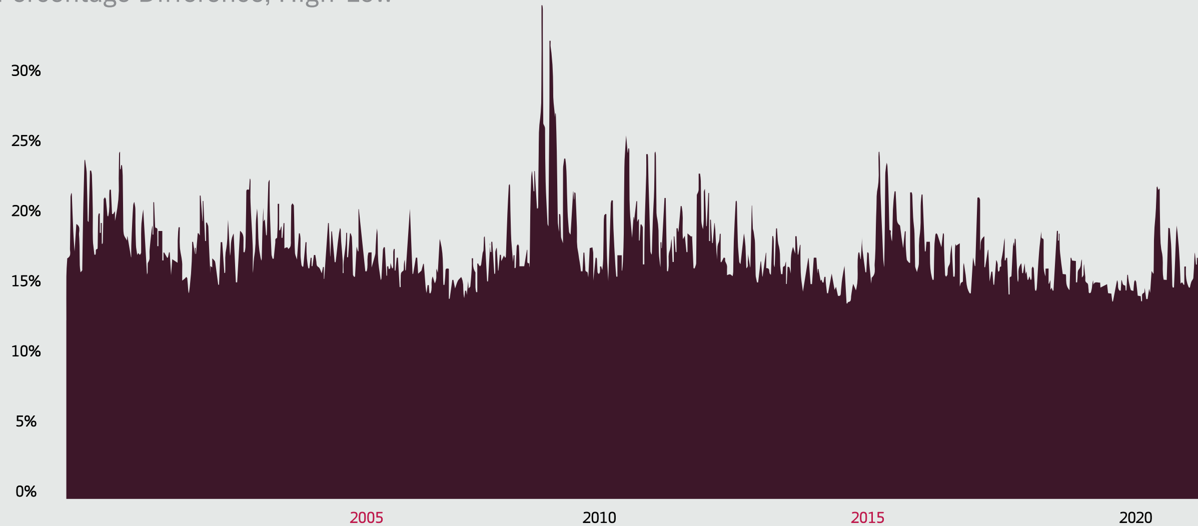
#1. Myth Number One: FX risks are immaterial

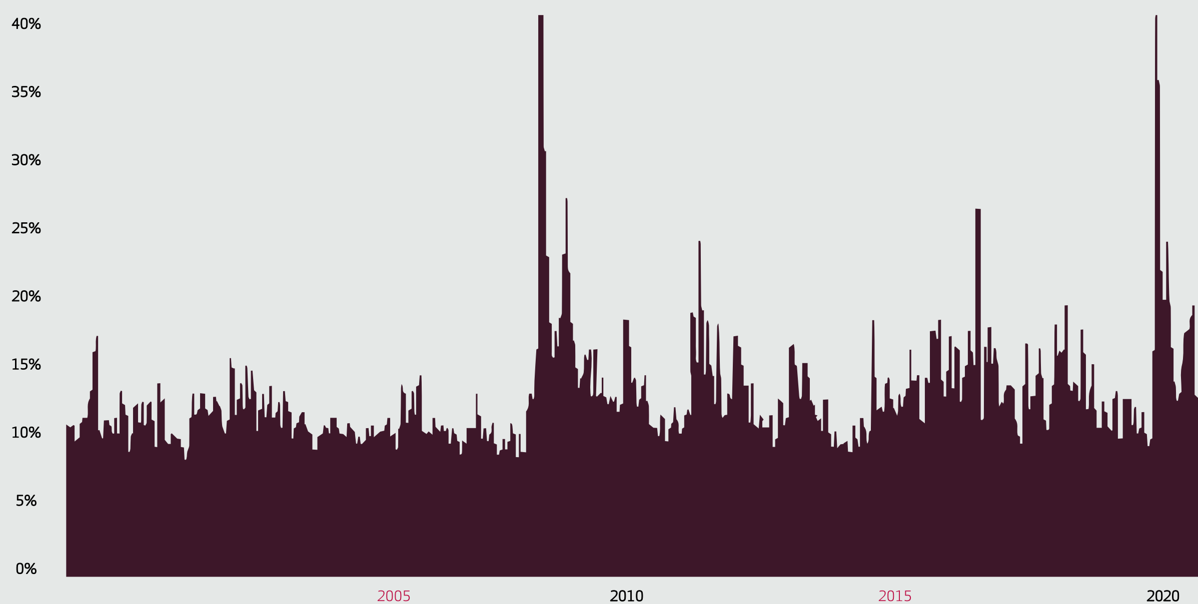
FX risk is often viewed as immaterial, either due to:

a) lack of visibility into the impact of FX variation on financial results

b) misconceptions about both the size and frequency of price movements in FX markets

While the former is truly a sticky wicket and beyond the scope of this writing, the latter reason is easily refuted by the below historical analysis of average FX ranges seen in select developed market currencies. Depending on where FX hits a business' financial statements, it can have a very material impact on its profitability, cash flow and even long term financial sustainability.





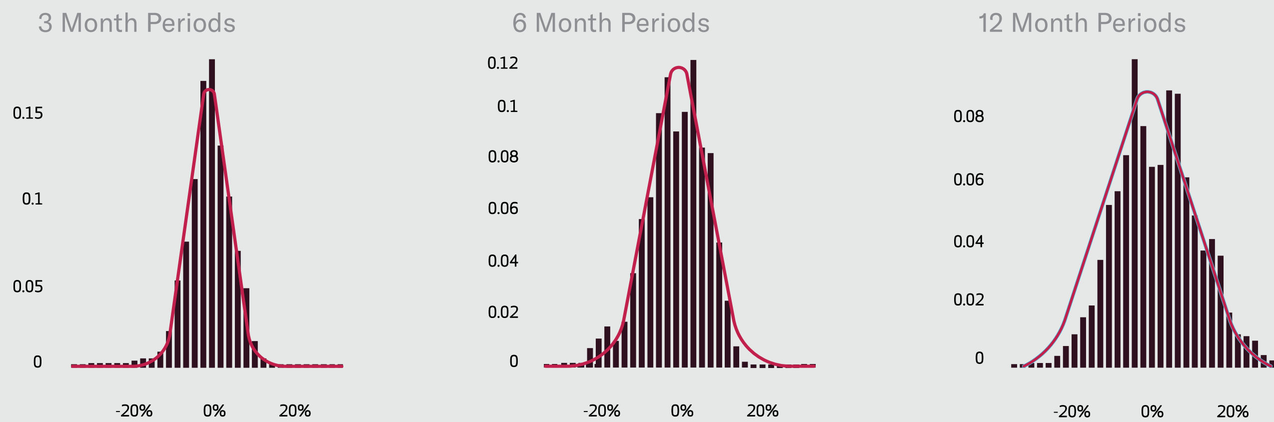
Consider the case of an importer with substantial cost of goods sold denominated in EUR funded by USD revenue. How does the historically low 12% monthly variation in the cost of its COGS seen in 2020 compare to variances seen in other line items?

Assuming $3M EUR per month in exposure at a EURUSD rate of 1.2000, a monthly variation of $432,000 USD directly hitting gross margin would be hard to handwave away for most businesses with less than $300M USD in revenue. Since this directly hits an importer's gross margin these types of figures are difficult to hand wave away for most mid sized businesses.

#2. Myth Number Two:
FX rate movements even out over time

EURUSD Historical Spot Return Distribution

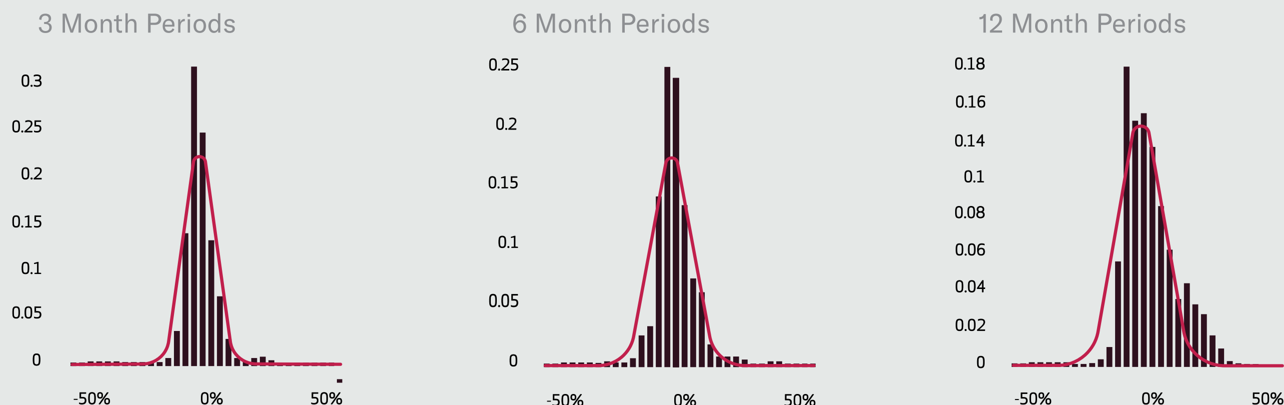
20-Year Return Distribution, Basis Points



Source: Bloomberg, Corpay Calculations 2021

USDMXN Historical Spot Return Distribution

20-Year Return Distribution, Basis Points



Source: Bloomberg, Corpay Calculations 2021

This is a biggie.

It is often assumed that the law of large numbers assures that FX rates 'even out' over time. This assumption can potentially lead to the destruction of an FX-exposed business. In fact, FX spot movements are not normally distributed, and this is true even for developed market currencies.

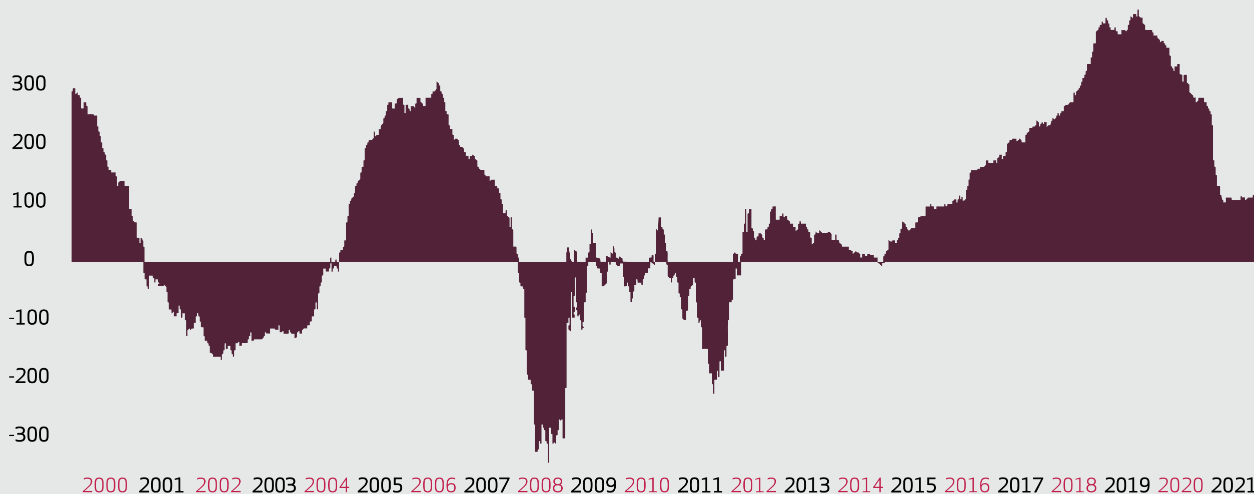
Potentially more impactful is the fact that the world's reserve currency, the US dollar, possess considerable skew in returns relative to the majority of its counteparts. Price action in that currency is especially asymmetric in bouts of risk aversion meaning FX volatility can exacerbate challenges arising in other parts of the business simultaneously. In other words, increased risk aversion often pushes up the US dollar against many other currencies, which can make things worse for many businesses already suffering due to the underlying circumstances causing the risk aversion in the first place.

#3. Myth Number Three:
FX hedging is necessarily expensive

EURUSD Forward Point History

Closing Rates – Weekly and Daily, Not Seasonly Adjusted

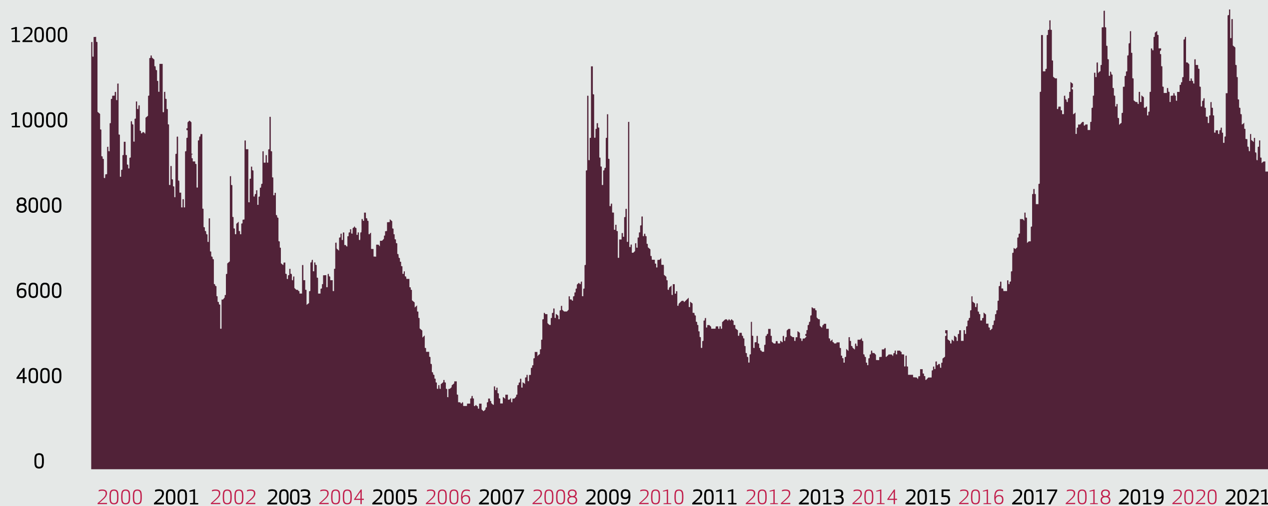
Source: Bloomberg, Corpay Calculations 2021



USDMXN Forward Point History

Closing Rates – Weekly and Daily, Not Seasonly Adjusted

Source: Bloomberg, Corpay Calculations 2021



Admittedly, this myth used to be somewhat true.

Hedging costs for forward contracts are largely a product of interest rate differentials between currencies. Post the global financial crisis of 2008/9 interest rates and rate differentials have plummeted. In fact, across many developed world currencies hedging costs are often far below the average range of movement in those currency pairs.

Additionally, savvy treasurers can exploit positive yield differentials by hedging forward sales or purchases when forward markets present with better pricing than spot markets. This is especially true for US based importers sourcing from higher yielding countries (i.e. their central banks have set relatively high interest rates) like Mexico, Brazil or South Africa.

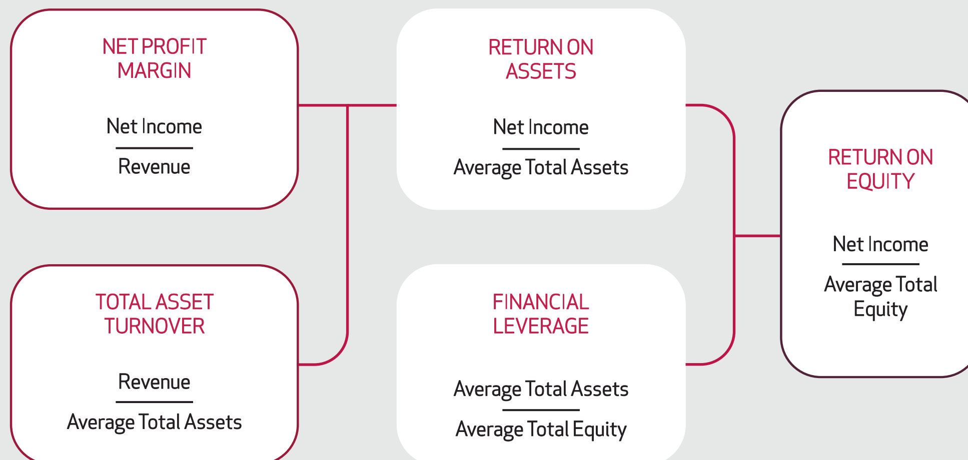
#4. Myth Number Four:
FX hedging has substantial opportunity costs

Traditionally, hedgers would have to post collateral to support hedging activities. This commitment of collateral ties up working capital and can present cash drag on portfolio returns.

Normally, collateral posted could amount to 3-5% of the notional amount being hedged. Fortunately, within the FX space in particular the provision of unsecured credit facilities by brokers and banks has become common practice. This has largely eliminated the need for collateral commitments or daily monitoring of margin requirements.

Looking Forward:

Overcoming myths while driving business valuations



FX hedging, when done right, can help drive shareholder value creation – and yet it often remains underutilized due to common misconceptions.

In an increasingly competitive environment for acquirers and operators, any tool that can reduce cash flow volatility, improve planning, and ultimately boost return on equity is all the more valuable. Proper FX riskmanagement – while often overlooked – can demonstrably play a critical role in enhancing competitive strategy, long run performance and ultimately valuation.

To learn more about how voliatility in the foreign exchange market can affect your business, or to get a complimentary consultation, connect with us at any time at InfoFx@Corpay.com.

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