CAXTON BUSINESS

CURRENCY RISK MANAGEMENT 2020

The impact of FX volatility and the use of hedging techniques in the UK

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Welcome

Over the past 20 years, globalisation has created a world of opportunity for British businesses. We now have access to cheaper goods and workers and the ability to sell to anyone, anytime and anywhere. This has also posed challenges, not least the need to deal in multiple currencies. More recently, protectionist trade policies, along with the mooted break-up of decade-old alliances, have played havoc with currency valuations.

We are all at the mercy of markets, whether you're importing raw materials from China, paying staff in Sydney or exporting goods to the US. If the pound is strong, your costs come down but it's harder to sell abroad. If the pound is weak, the opposite is true. The result is an unpredictable and unstable bottom line.

At the same time, you can't change pricing too often if you want to retain customers. Many companies need to guarantee prices throughout a product life cycle of six to twelve months. Yet absorbing potential losses made while transferring currency eats into profits.

More than 300,000 UK businesses trade with the EU alone. That makes foreign exchange volatility a pressing concern for CFOs at companies across the UK.

We asked financial directors and controllers how they'd been impacted by currency volatility. They revealed which currencies they exchange and why, and what happens when the markets drive up the cost of doing business. They also talked about the measures they take to manage risk and their predictions for sterling's future performance.

What emerges is a portrait of a financial community with exposure to overseas markets, grappling to find a timely solution to manage FX risk. Not only are they worried about how they can absorb losses when currency fluctuations impact their bottom line, they also hold widely different views about the future of sterling.

Jane-Emma Peerless
Caxton Business
Chief Commercial Officer

"We are all at the mercy of markets, whether you're importing raw materials from China, paying staff in Sydney or exporting goods to the US"

EXECUTIVE SUMMARY

Our survey quizzed 150 financial directors, controllers and managers across the UK about their experiences of and attitudes towards currency volatility. Respondents ranged from small businesses with fewer than 50 staff to large enterprises with more than 1,000 employees. All spend at least £500,000 per year on foreign currency transactions.

The results show that companies of all sizes are affected by the uncertainties of the FX market. All are concerned by the risk it poses to their profitability and business planning.
However, we found a marked difference in the reasoning behind company's FX trades and their predictions for sterling, dependent on the size of the company.

Here are some of the key insights:

76%

 # businesses who say currency volatility negatively impacts their bottom line.

3 in 4

3 in 4 (76%) are concerned about their company's ability to manage the risk posed by currency volatility.

69%

 # companies that absorb losses from currency exchange.

29%

pass the costs on to customers.

75%

The number of small businesses that have seen a negative impact from currency volatility.

The largest businesses are less exposed to harm from unpredictable markets.

38%

Only 38% of the smallest businesses surveyed always hedge to manage risk.

49%

Overall, 49% only hedge some of the time.

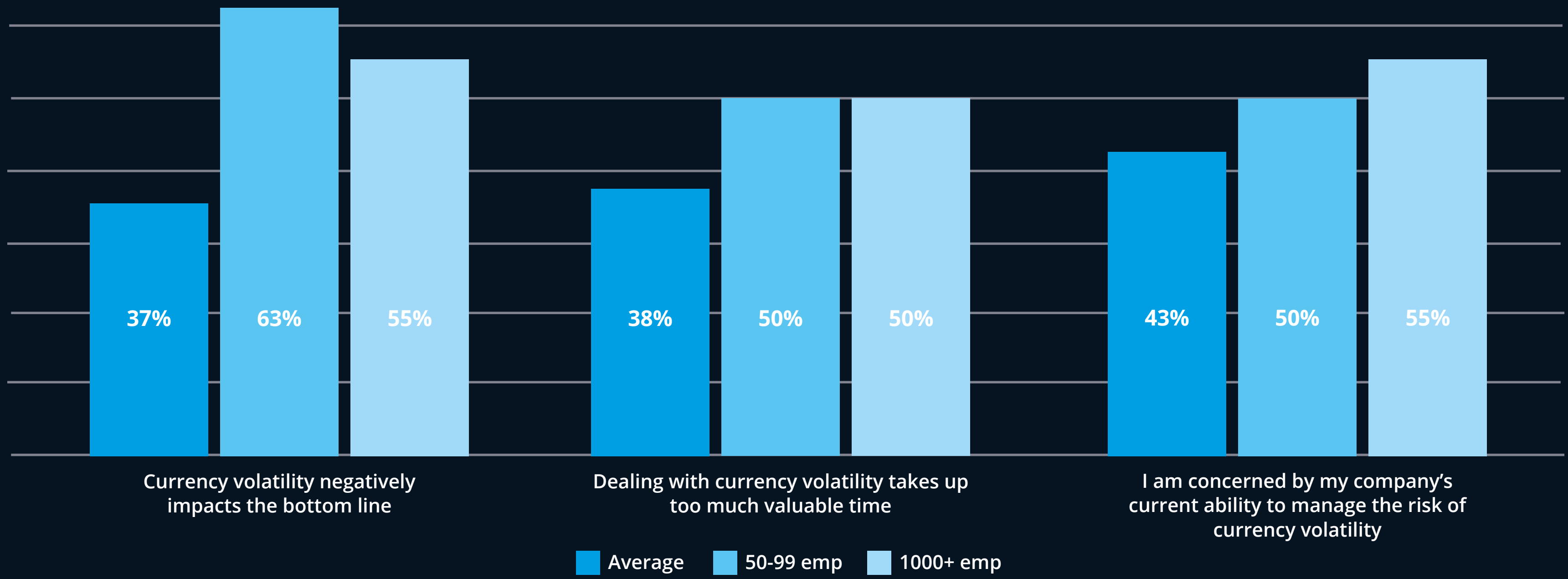
65%

Two-thirds of companies say hedging "definitely" works.

3 in 4

This rises to 3 in 4 for the smallest (75%) and largest (74%) companies surveyed.

CURRENCY RISK MANAGEMENT



Three quarters of UK businesses are concerned about the impact of currency volatility

Sterling's recent rollercoaster ride is a major headache for financial decision makers in the UK.

Three quarters (76%) of financial directors are concerned about their company's ability to manage the risk posed by currency volatility. The same number say that fluctuations in the value of the pound negatively impacts their bottom line. 73% point to the inordinate amount of their time they spend managing this particular risk; time that could be better spent on proactive, strategic initiatives.

It's interesting that these feelings are shared most strongly by financial directors at either end of the spectrum in terms of company size. 63% of the smallest companies surveyed and 55% of those with more than 1,000 employees strongly agree that volatility impacts the bottom line. The average was just 37%.

The same correlation between large and small companies emerges when it comes to the time spent dealing with currency volatility and concerns over the company's ability to manage the risk.

When currency volatility increases costs, it's a lose-lose

Many businesses rely on suppliers in Europe, Asia and elsewhere to help deliver their product or service. Unfortunately, thanks to FX market fluctuations, the contracted price rarely matches the final bill.

The last few years have seen the pound decline against other major currencies. This is good news for the nation's exporters, however, a real challenge for those importing goods from abroad, as a weak pound increases the cost of doing business.. The question is: how do companies respond?

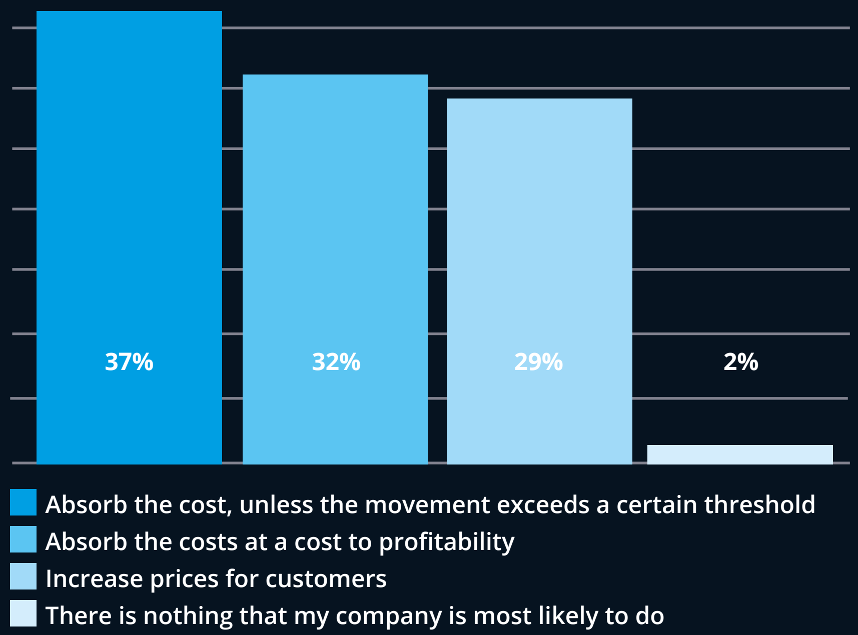
According to our survey, more than two thirds absorb these costs, at least to a certain point. 32% say they will always take the hit themselves. A further 37% of businesses draw a line in the sand – deciding only to pass the costs on if currency fluctuation exceeds a certain threshold.

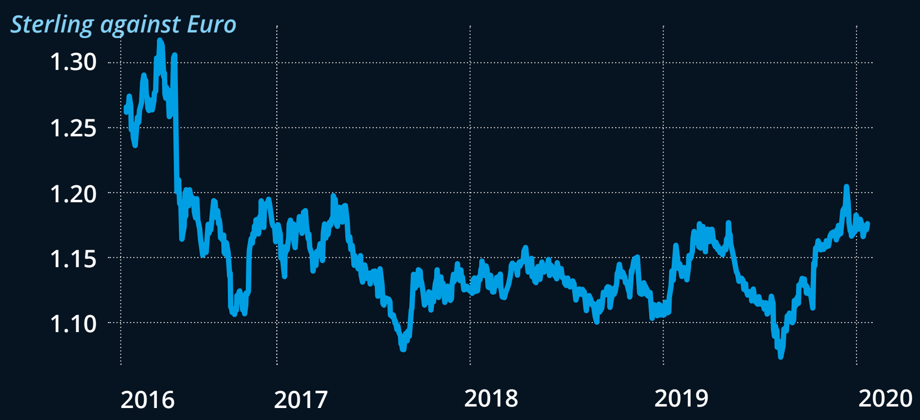
Consider the impact of such a policy on profitability: When sterling weakens, businesses may be forced to abandon or revise targets despite sales matching expectations. Investors are then disappointed and businesses may need to tighten their belts. This can result in job losses and might even create an existential threat to the company.

The alternative is to pass on the cost to customers, either elsewhere in the supply chain or to the end consumer. 29% do just that. But neither is likely to have a happy outcome.

Customers might look elsewhere – for example to a rival that's prepared to absorb those costs.

When currency volatility increases the cost of doing business, what would your company most likely do?





No clear view on sterling's future among UK businesses

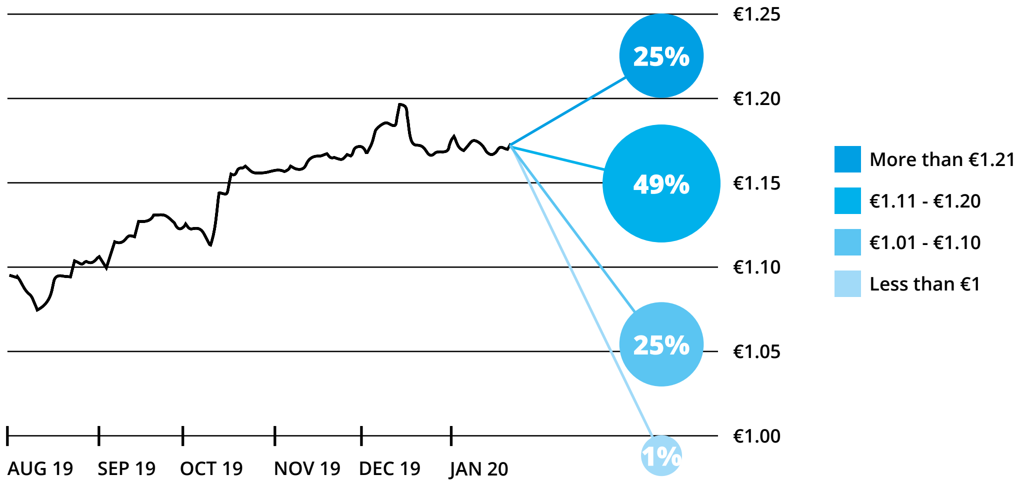
Compounding the problem of the cost of volatility is unpredictability. As if to exemplify this unpredictability, when asked how the pound will perform against the euro and dollar, respondents cast their vote widely as the graph shows.

However, a deeper dive reveals a fascinating pack mentality among companies of similar size. Essentially, the bigger the company the more bullish they are on the pound's chances. The smaller the business, the more downbeat their assessment.

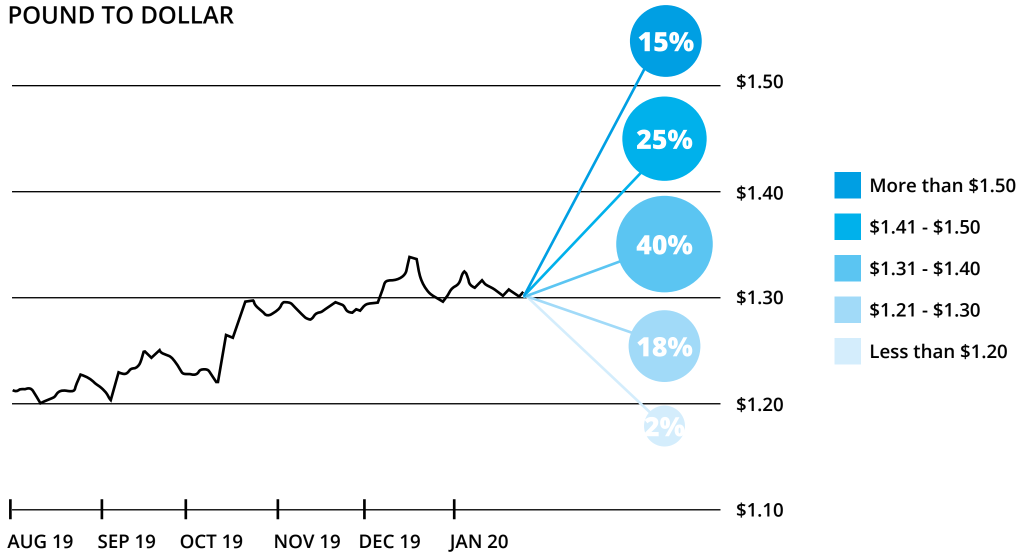
More than a third of the very largest companies surveyed (36%) thought the pound would be worth more than €1.23 in six months. Roughly the same amount (32%) asserted it would be worth more than $1.50 by that time. Not a single company with fewer than 250 employees agreed.

Conversely two thirds (63%) of the smallest companies (50-99 employees) worried that the pound would be worth less than €1.10 or $1.30. The number of financial directors at large enterprises (more than 1,000 employees) who thought the same was just 23% and 14% respectively. Either way, there is a lot of confusion when setting a budget rate for 2020.

POUND TO EURO



POUND TO DOLLAR



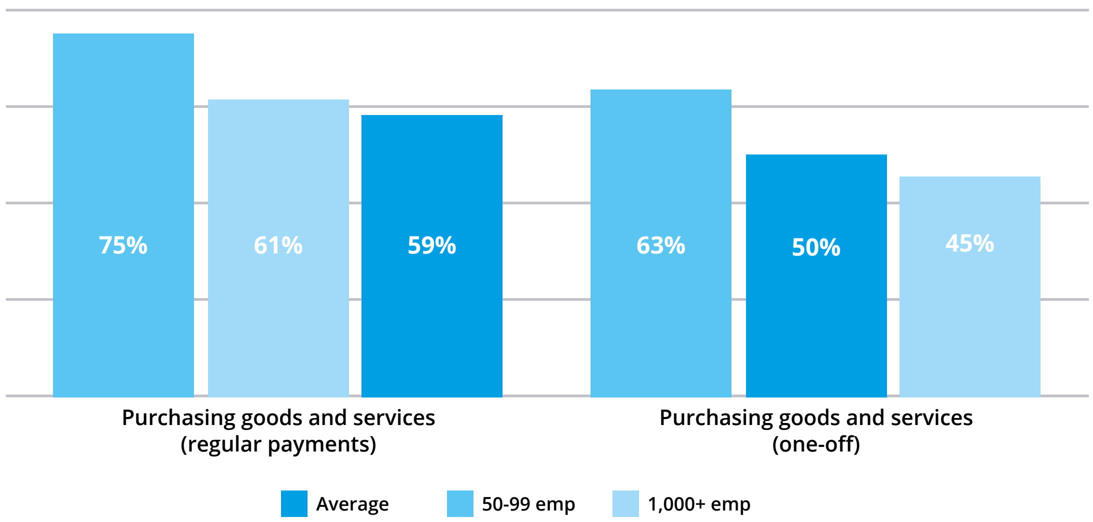
Why are UK businesses exchanging currency?

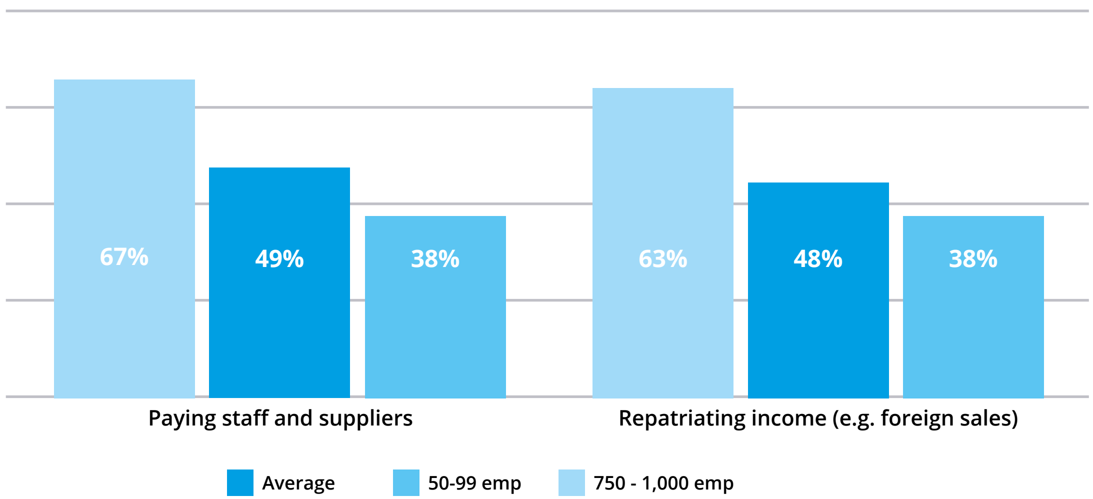
More than half of all companies are buying goods from abroad. 59% make regular payments to suppliers in Europe and beyond, while 50% make one-off payments here and there – either in addition to or instead of those ongoing bills.

Slightly less than half pay staff and suppliers located abroad (49%) and need to bring foreign sales revenue back to the UK (48%). All three activities expose them to currency market volatility.

Once again, there's a marked difference between the needs of small business and large enterprises. Three quarters of companies with 50-99 staff make regular payments abroad to buy goods and services, and 63% make one-off purchases. By contrast, only 61% of large businesses with more than 1,000 employees make regular payments and just 45% make those occasional purchases.

On the other hand, 67% of companies with 751-1,000 employees are paying staff and suppliers abroad, and 63% repatriating income. Just 38% of the smallest businesses surveyed do the same.





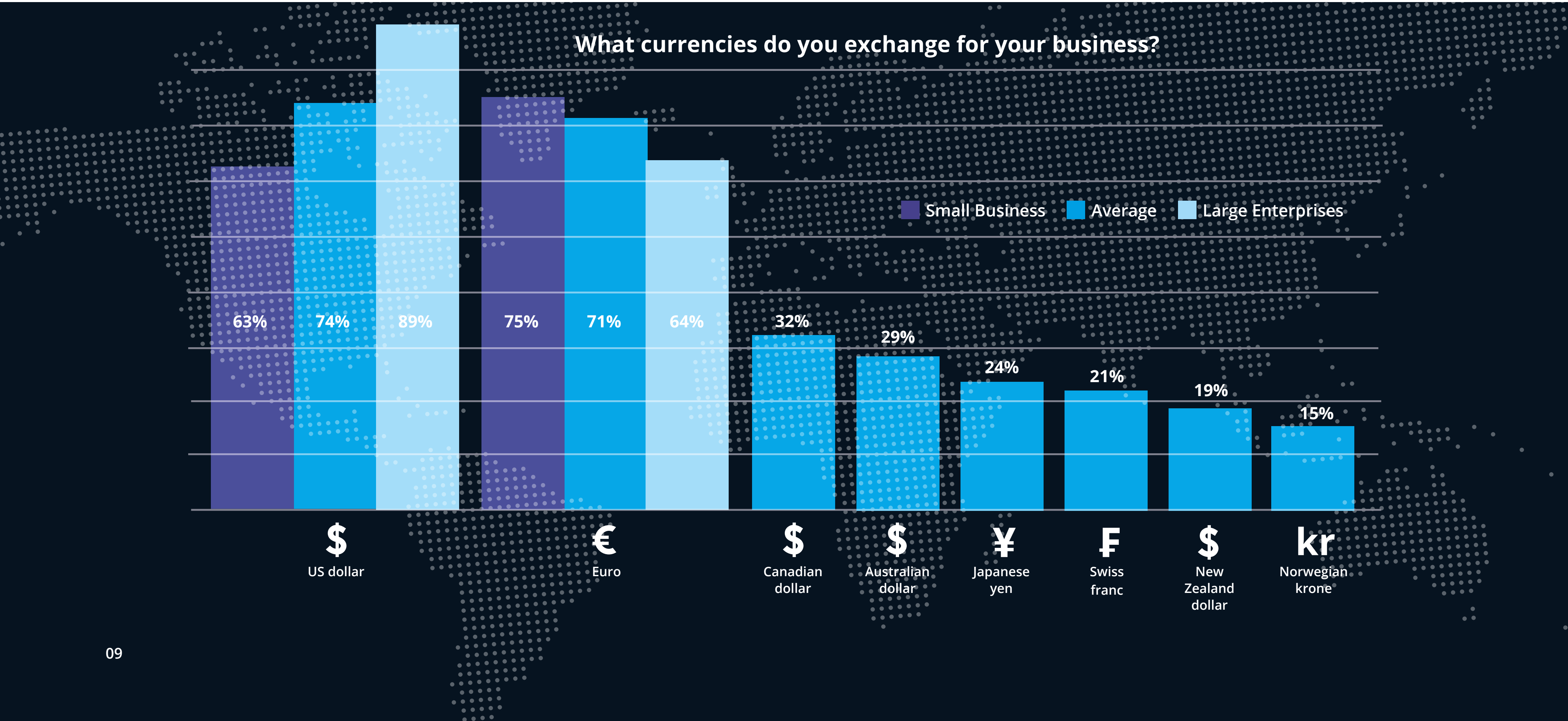
Which currencies are UK businesses primarily exposed to?

Unsurprisingly, the US dollar and euro top the chart of most transacted currencies. 74% of UK companies exchange pounds into US dollars and vice versa, slightly ahead of the euro at 71%.

The Canadian dollar (32%) is also popular, especially with large enterprises (41%). The Australian dollar and Japanese yen are bought and sold by around a quarter of businesses.

Small businesses appear to favour suppliers and customers closer to home. Three quarters of companies with 50-99 employees exchange euros, compared to 64% with more than 1,000 staff.

Those large enterprises, are more likely to deal in US dollars. 89% of companies with 751-1,000 employees buy and sell the greenback as opposed to just 63% of the smallest businesses surveyed.



Impact of currency volatility on the bottom line

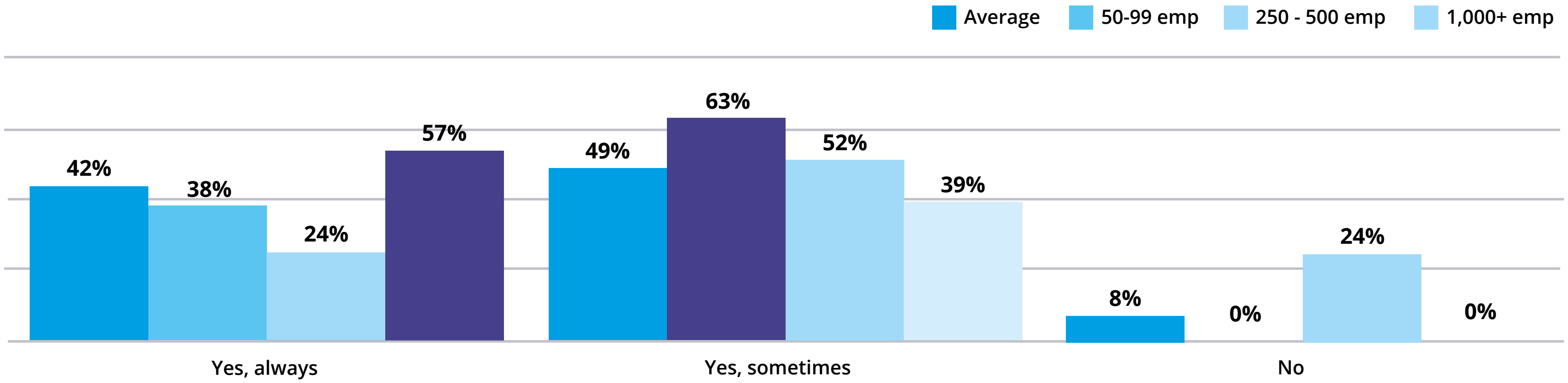
While volatility makes foreign exchange unpredictable and therefore potentially stressful, that's not to say it's always a bad thing for the business. That's why, when we asked financial directors to describe the impact currency volatility has had on profits over the past 12 months, not everyone was crying into their spreadsheets.

We asked respondents to score the impact of currency market volatility out of ten, where one is extremely negative and ten extremely positive. The mean score was more than seven, which shows sterling's rollercoaster ride hasn't been all bad news.

This demonstrates the difference between large and small companies; three quarters of companies with 50-99 employees marked a score of five or less, whereas half of the largest enterprises gave a score of nine or ten.

This correlates with our earlier finding that large enterprises tend to sell abroad – benefiting from a weak pound – while small businesses find their money going less far when buying goods and services.

On a scale of 1 – 10, where 1 is extremely negative and 10 is extremely positive, how would you describe the impact currency volatility has had on your profits over the past 12 months?



Hedging is widely used to manage the risk of trading currencies

Perhaps the main reason some companies are upbeat about the impact of volatility is that they are taking active steps to mitigate risks. More than 9 out of 10 of our survey respondents use 'hedging' techniques (see next page), either sometimes (49%) or always (42%).

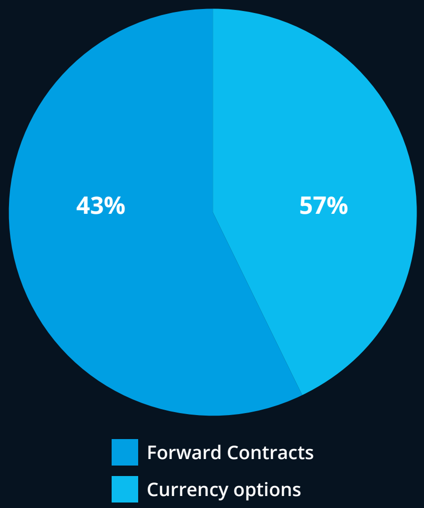
Large companies, as you'd expect, are most likely to fall into the second camp. 57% of those with more than 1,000 employees say they always hedge, against 38% of the smallest companies we surveyed.

63% of those smallest companies say they use hedging techniques 'sometimes'. This could be because annual FX flow is too small for it to be a priority (though all companies surveyed spend at least £500,000 pa on currency exchange). It might also be that they lack the structures or resources to make sure they hedge as a matter of course.

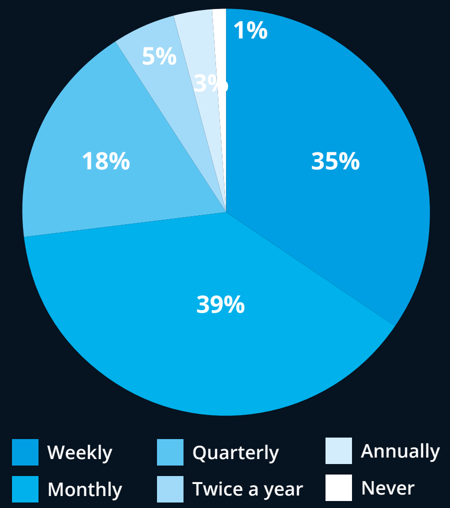
Midsize companies are the only group who are relatively lacking in take-up of risk management strategies. Of the companies with between 250-500 employees, 1 in 4 say they don't hedge at all (against an average of just 8%).

"1 in 4 companies with between 250-500 employees say they don't hedge at all."

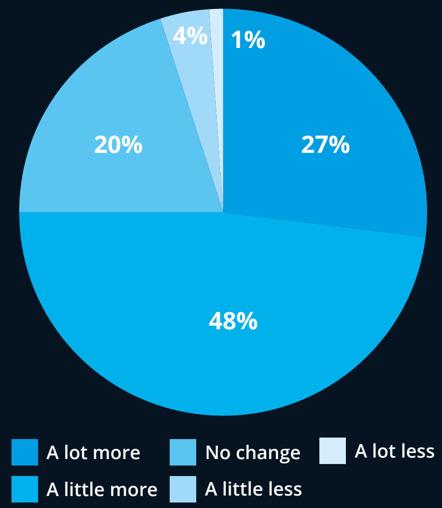
Which hedging techniques are you currently using?



How often do you review your risk management strategy?



Are you hedging more or less often than in the past?



Companies hedging more, prioritising currency risk mitigation

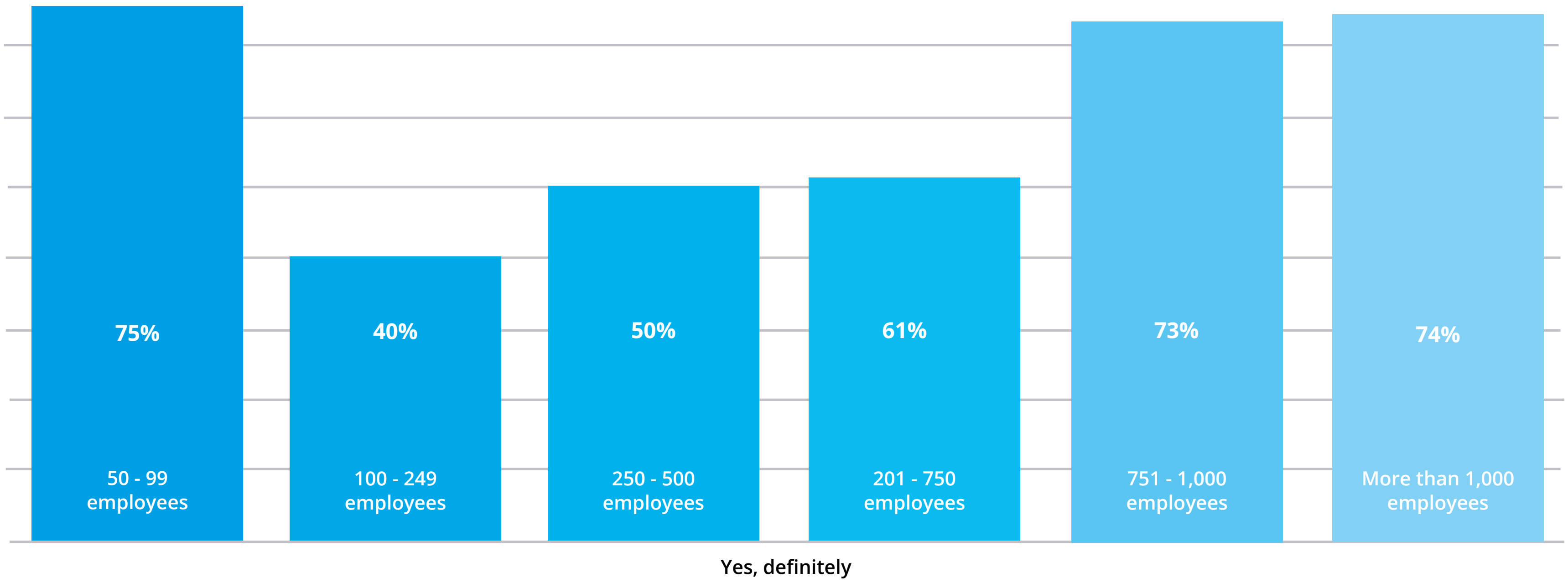
Most businesses say they use forward contracts, the simplest hedging technique.

Currency options, a more sophisticated hedging strategy requiring specialist knowledge are unsurprisingly less well-used. No company with 50-99 employees said they used this practice.

The majority of companies surveyed review their strategy on a weekly (35%) or monthly (39%) basis. Fewer than 10% said it was reviewed less often than quarterly. The fact that financial directors are prepared to spend so much time on it is a measure how seriously they take the risk of currency volatility.

Another reason for this constant review is that most companies are hedging more than they were. Almost half (48%) said they are doing it a little more than in the past, with a further quarter (27%) saying it was happening a lot more. Only 1 in 20 said they were hedging less than they were.

Have hedging strategies had the positive impact you anticipated?



Whatever form it takes, hedging could work for you

The good news is that, whatever form it takes and however often it's reviewed, hedging works for the majority of companies – at least according to our respondents. Two-thirds (65%) said hedging strategies 'definitely' had the positive impact they'd anticipated. A further third said they had 'somewhat' worked as planned.

The very largest companies are best pleased with the results. Three quarters (74%) of companies with 750+ employees said hedging definitely had the positive impact they wished for.

65%
POSITIVE IMPACT

Clarification of hedging

The solution to currency market volatility and its impact on cash flow uncertainty is hedging. Simply put, hedging means transferring currency in such a way as to limit your exposure to volatility in the market.

Rather than exchanging money on the day it needs to be sent, savvy businesses lock in favourable rates in advance. This helps avoid sudden movements in the currency market that would otherwise have eaten into profits.

It's even possible to have the best of both worlds. Creating a strategy that includes Currency Options allows companies to buy currency in advance, but also potentially take advantage of a favourable shift in currency value.

FORWARD CONTRACT

Lock in an exchange rate for a period of up to 24 months

CURRENCY OPTIONS

All the benefits of a forward contract, but with the added bonus of being able to respond to the market if it moves in your favour.

ABOUT THE SURVEY

The research was conducted online by Censuswide between 23.07.2019 - 01.08.2019.

The 150 respondents are financial directors, controllers, and managers responsible for expenses and FX payments in companies with 50+ employees and which spend £500k on for foreign currency transactions per year.

Censuswide abide by and employ members of the Market Research Society which is based on the ESOMAR principles.

CENSUSWIDE
THE SURVEY CONSULTANTS

MANAGING CURRENCY RISK WITH CAXTON

Customers don't like surprises, especially if it means higher prices. If you can predict your costs over a twelve month period it means you can afford to price your products competitively without eroding your profit margin.

Implementing a hedging strategy can save money and boost your bottom line. By choosing a specialist FX provider you can also do away with bank fees and charges.

Hedging lets you lock in a set rate, giving you peace of mind and knowable currency costs.

Reassure shareholders or investors with a smooth projection of costs and profit over a product's life cycle. Iron out spikes in your financial accounts caused by volatile currency charges.

An effective FX risk management strategy means you protect your profits whilst you focus on the day-to-day running of your business.

PROTECTING PROFITS

EASE OF FORECASTING

STABLE CASH FLOW

COST CERTAINTY

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