WHITE PAPER

Managing Foreign Exchange Risk with EDC Guarantees

As any exporter knows, changes in the foreign exchange (FX) rate of the Canadian dollar can present unpredictable risks to your profit margins and cash flow. Fluctuating rates mean more guesswork when you're working out your budget forecasts, and they make it harder to know exactly how much you'll get paid when you complete a contract. And when payment terms are long, as they usually are in international transactions, this lack of predictability can become even more of a hazard to your bottom line. This white paper examines the basics of FX risk, and how EDC's Foreign Exchange Facility Guarantee (FXG) can help you manage it.

TABLE OF CONTENTS

INTRODUCTION

Canadian exporters generally agree that FX fluctuations can seriously erode their profit margins and cash flow. Even so, a recent EDC study shows that few exporting companies manage their FX risk in an aggressive way, often because it's not seen as cost-effective or simply because it appears to be too complicated. But FX volatility is a fact of life in today's global economic environment, and ignoring it can be dangerous – especially since good FX risk management can offer tangible benefits such as these:

- It helps you identify the true effects of FX fluctuations on your profit margins, even when your financial statements don't directly reveal them. This means you won't look for the cause of shrinking profits in the wrong places – in production costs, for example, rather than in hidden FX losses.
- Accurately knowing the sources and effects of your FX risks can help you reduce or eliminate them. This can improve the accuracy and reliability of your financial forecasts.
- Better forecasting will in turn make your cash flow and your profits more predictable, which will sharpen your company's competitive edge.

In short, by managing your FX exposure properly, you can take better control of your bottom line.

BASIC FX RISK MANAGEMENT

While effective FX risk management is far from a trivial undertaking, especially at the setting-up stage, it's well within the reach of any company that makes the effort. In essence, it requires these steps:

- You **analyze your business's operating cycle** to identify where FX risk exists. This helps you determine the sensitivity of your profit margins to FX fluctuations and the stages of the operating cycle in which you need protection.
- You **calculate your exposure** to FX risk. This covers both unconfirmed risk (the risk that exists before a sales agreement is finalized) and confirmed risk (the risk that exists after a firm sale is completed but you haven't yet been paid). Once you know your exposure, you can decide how much risk coverage you need.
- You **hedge your FX risk**. "Hedging" simply means that you use specially designed financial instruments to lock in the exchange rate so that it remains the same over a specified period of time. Hedging allows you to cover all or most of your risk and thus reduce your vulnerability to adverse shifts in the FX rate.
- You **create an FX policy** and follow it. You establish the FX risk criteria, procedures and mechanisms that will underpin your FX risk management program, and implement this policy across the company.

You can find much more detail about doing this in EDC's new guide to FX risk management, **Building a Foreign Exchange Policy**.

FX FACILITIES, HEDGING AND YOUR BOTTOM LINE

There are numerous ways to hedge, but as an exporter you're most likely to use an "FX facility," which you'll obtain from your bank. An FX facility resembles an operating line and can support various types of financial instruments (or "hedges"), all of which are designed to secure a specific exchange rate for an export contract so you won't get any surprises at payment time.

Hedging by means of an FX facility can have a considerable effect on your firm's bottom line. Suppose, for example, you secure a European contract denominated in euros, and you and your buyer agree on a price of €1.5 million. When you sign the contract, the exchange rate is CAD 1.616 per euro, and on this basis you're projecting the contract to be worth CAD 2,424,000.

The Canadian dollar seems to be stable at the time of signing, so you don't bother to hedge. But by the time you get paid, unfortunately, the dollar has fallen to CAD 1.4868 per euro, so the contract is now worth only CAD 2,230,200 – a drop of 8 per cent, which you could have avoided by setting up an FX facility with your bank and using a hedge to lock in the original exchange rate.

BUT CAN YOU PROFIT FROM FX FLUCTUATIONS?

It's true that if you don't hedge a contract, a positive FX movement may increase the contract's value by the time you actually get paid. In the scenario above, for example, suppose the dollar rose instead of falling, say to CAD 1.7155 per euro. In this case, the contract would be worth CAD 2,573,000 – an increase of 6 per cent over its value when it was signed.

At first glance, the possibility of such a benefit may seem like an argument against hedging – if you hedge, you can't gain from a favourable rate movement, since the exchange rate is locked in by your hedging instrument. But if you look back at FX fluctuations over time, it is clear that these movements are extremely unpredictable. So you can never be sure, for any particular un-hedged contract, whether FX shifts will bring you a gain or a loss.

In fact, there are no documented cases of exporting companies that have consistently made money over time by relying on FX fluctuations. If you try to do this, you are in fact taking a significant risk with no reasonable expectation of gain, a strategy that flies in the face of good management. To put it another way: attempting to predict FX shifts may make sense if you want to be a currency speculator, rather than a businessperson, but it makes no sense at all if you want to establish your company for the long term. To do that, you need solid management practices, and currency hedging is one of them.

FX HEDGING AND YOUR WORKING CAPITAL

The essential advantage of a hedge is that it protects your profits from unfavourable movements in the FX rate. The drawback is that your bank will want security for any FX facility it issues to you, and this requirement will necessarily diminish your working capital.

To give an example: one common type of hedge (the "forward contract") commits you to pay your bank a specific amount of foreign currency on a specific date – even though, when that day rolls around, you may not have enough of the foreign currency to do so. If you default, the bank may suffer considerable losses, so it will require security for the contract.

To get this security, the bank will usually carve the necessary amount out of your operating line, which means you end up with less working capital – possibly a lot less, since the security may be up to 15 per cent of the value of the forward contract. This could squeeze your cash flow, make it harder to take on new business, hinder your investment plans and generally make it more difficult to do business.

Fortunately, there's an EDC solution designed for just these situations: the **Foreign Exchange Facility Guarantee** (FXG).

HOW AN FXG CAN HELP

An FXG provides a 100 per cent guarantee of the security your bank requires for providing you with an FX facility. Once the guarantee is in place, the bank won't need to take the security from your operating line, which means you'll have full access to all your working capital.

As an example, suppose your company has several U.S. contracts that will generate USD 3 million in sales over the next year. But since the payments will be in U.S. funds, you don't know exactly how much that USD 3 million will be worth when converted into Canadian currency. If the FX rate shifts unfavourably, you may end up with substantially fewer Canadian dollars than you expected, which will reduce your profit margin.

To protect your profits, you ask your bank for a one-year FX facility worth USD 3 million. This will allow you to convert USD to CAD, at a fixed rate and regardless of currency fluctuations, up to a total of USD 3 million. Before the bank will provide the facility, however, it wants security of 15 per cent of the facility limit, or USD 450,000. This will be carved out of your operating line – but since your line is only CAD 2 million, this will shrink your cash flow to dangerous levels.

EDC's FXG provides the answer to your dilemma. Because it can guarantee 100 per cent of the USD 450,000 security, your bank knows its risk is covered and can now provide the FX facility for the full USD 3 million. With that in place, you won't have to worry about exchange rates for a full year, and you'll have access to all of your working capital. And that means you'll be able to manage your cash flow and budgeting more easily, protect your balance sheet, pay your suppliers up front and take on more business.

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WP-MFER-0514

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