SHOULD YOU PROTECT YOUR BUSINESS AGAINST CURRENCY FLUCTUATIONS?

Needless to say, 2019 was a pivotal year for the foreign exchange market, with the unequivocal conflict between Beijing and Washington having received the most global attention by far. The quarrels between the two major powers had a considerable impact on trade, and consequently, on the growth of most industrialized countries. Of course, Canada was no exception, occupying a front-row seat within the midst of escalating tensions between Donald Trump and Xi Jinping.

The current economic circumstances and uncertainty stemming from the growing disputes between China and the United States are affecting the USD/CAD pair, which is having a direct impact on the country's importing and exporting companies. For its part, the Canadian dollar appears to want to remain frozen in face of the news, despite the Bank of Canada's decision to weather the storm without changing the key rate. In fact, the pair is going through a period of low volatility in relation to the American dollar.

This situation often raises the following question among entrepreneurs:
"Should I be hedging against currency fluctuations?" To answer that question, this article presents a number of factors to be taken into account in determining whether or not currency hedging is called for.

1. THE ABILITY TO "PASS ON" CURRENCY FLUCTUATION

To assess whether or not currency hedging is required, it is first important to quantify and qualify the ability of a business to "pass on" currency fluctuation to its clients and business partners. The fact is that, in the very short-term, certain industries or companies are able to transfer an adverse movement of foreign currency to others.

Example:

ABC Fruits is a company that primarily imports oranges from Florida and does business with large retailers in Quebec who are committed to buying a set quantity of fruit to meet the needs of their customers. Thus, regardless of the Canadian dollar's performance vis-à-vis its American counterpart, ABC will always be in a position to readily sell its oranges to retailers at a higher price than it paid in order to reflect the higher value of the American dollar. **In view of this particular dynamic, ABC Fruits does not need to resort to currency hedging as a way of counteracting the appreciation of the US dollar because it can quickly, and without creating too much friction, raise the prices charged to customers (due to the higher USD).** For their part, retailers will transmit the price increase related to the low loonie to end consumers — in this case, grocery shoppers.

2. THE TIME BETWEEN YOUR ORDERS AND THEIR PAYMENT

The second factor to consider in determining whether or not to be currency hedging is the amount of time that elapses between when you place your orders and when you actually issue payment.

Example:

XYZ is a textile company that needs to order its new spring collection in October when the USD/CAD exchange rate is at 1.3200. However, unless it adopts a hedging strategy, XYZ has no guarantee that the rate will still be at 1.3200 when the time comes to pay for its order. The rate could have come down (1.2800 USD/CAD) or have gone up (1.3700 USD/CAD). **In that case, instead of paying the expected $200,000 CAD for its merchandise, the company's invoice could be in the amount of $207,575 CAD, which would lower its profit margin.** Although fictional, this scenario is indeed the reality of numerous small, medium and large-sized businesses in Canada. Here at Laurentian Bank, our specialists help foresee and avoid these situations by providing expert advice regarding custom-tailored hedging strategies.

3. COMPETITIVENESS OF THE ACTIVITY SECTOR

The third and final factor in determining whether or not to resort to hedging strategies is the competitiveness of your activity sector. Indeed, if none of your competitors use instruments that guarantee or partially guarantee an exchange rate at a future date, you should do so. Otherwise, you will be exposed to a substantial competitive risk in the event that the rate changes to your disadvantage.

Example:

Company XYZ has committed to purchasing $1,000,000 USD at 1.3300 USD/CAD for a full year. During this period, the rate takes a drastic dip to 1.2800 USD/CAD. **In this case, XYZ would be obliged to respect its commitments by continuing to procure US dollars at 1.3300, while its competitors would be benefiting from the more favourable market rate of 1.2800 USD/CAD.** That being said, if all of XYZ's competitors are foreign, it becomes all the more important for the company to explore hedging strategies that allow it to protect its purchases and sales denominated in foreign currency, given that in the scenario outlined, its competitors would not be affected by functional currency changes. Note that we can offer tailored strategies to help you benefit from currency appreciation in your favour up to certain levels.

DETERMINING THE APPROPRIATE HEDGING STRATEGY

Now that you are familiar with the factors that allow you to determine whether or not hedging is called for, it is important to establish the hedging ratio, the term, as well as the financial instruments that will meet your needs.

Hedging Ratio

We recommend that the ratio be clearly correlated with the certainty of cash flows. In other words, if you are certain to receive $100,000 USD between now and October 31, you could decide to take out a financial contract maturing on that date for 100% of the value of your contract. If you have any doubts, the hedging percentage could be reduced to 50%, thus limiting your commitments but also entailing greater risk related to currency fluctuation.

Hedging Term

If the hedging ratio remains closely correlated with certainty of cash flows, the hedging term will depend primarily on the payment deadlines of your suppliers or clients. In that regard, an extensive review of your working capital should be conducted to clearly identify your needs. Moreover, note that there is a clear link between the certainty of cash flows and the term.

Example:

123 Quebec Inc. sells the majority of its industrial products in the United States and abroad using the American dollar. Having done its homework, the company decides to hedge its sales in foreign currency. In so doing, the company hedges its account receivable at 90% and its sales forecasts for under one year at 50%. With this strategy, it is easy to understand the link between certainty of cash flows associated with a term and an innovative approach aimed at minimizing fluctuations of the Canadian dollar vis-à-vis other currencies.

All of these notions may seem complex, so do not hesitate to call upon our team of experts. Whether or not you need a hedging strategy to counteract your exchange rate risk, the Laurentian Bank Business Services' foreign exchange team can help you optimize your transactions. By talking to one of our foreign exchange advisors, you can obtain a free personalized service catered to your specific reality, and ultimately, you can save significant sums of money. Remember, you don't have to be a Laurentian Bank client to benefit from the services of our traders, who can offer you the most appropriate hedging tools and advice to meet your particular needs.

If you have any questions or would like more information, we invite you to arrange an appointment with one of our foreign exchange advisors via e-mail at fx@blcmf.com, or by calling 514 350-2910.

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