How to Avoid Being a Bad News Story in Q3 and Beyond

Author name here

Foreign currency volatility, now at a five-year high, is impacting the bottom lines of companies everywhere, showing up in current revenue and earnings, and in deferred earnings as well. The media is enjoying a feeding frenzy, with mass outlets like Fox Business News, Forbes, CNBC, and PBS extolling the virtues of winners that remain unaffected and the vices of losers that missed expectations in the second quarter. Thanks to this media spotlight, foreign currency exposure is no longer relegated to the floor of the treasury; the topic has also become top of mind for CEOs and CFOs who feel a new sense of urgency to understand and manage the FX volatility behind it.

Ebay, IBM, and Delta made headlines for missed forecasts and lackluster sales due in part to the decline of the euro, which recently sank to its lowest low in four years. The same volatility also caused a $19.5 million loss for the AIDS drug giant Gilead Sciences and a 3% reduction in sales at Mattel. U.S. Steel, another big loser, racked up a $25 million hit and cited “net foreign currency remeasurement losses on intercompany loans” as the culprit.

To many CFOs and CEOs, not to mention to analysts, investors and journalists, such excuses don’t cut it, especially when other companies seemingly escaped the volatility of Q2 unscathed. Take Google, for instance, called out by both Fox News and the Wall Street Journal for its comparatively positive results, credited to a sophisticated currency and hedging strategy. “The aggressive strategy helped the Internet search and advertising giant surprise analysts, many of whom had downgraded their forecasts for Google’s revenue based on fears of a big foreign-exchange hit,” wrote Michael Casey of the Journal.

Fox Business News also called out Fiat for posting second quarter earnings twice as high—the supposed positive side of currency fluctuations. But the goal of managing foreign currency risk is not to gain from speculation—it is to minimize the impact of foreign currency volatility to better manage predictability on earnings. After all, a company like Fiat that has an up quarter due to currency moves is just as likely to have a down quarter next time due to the same. As one senior international treasury manager put it, “Our philosophy of foreign exchange is to eliminate FX impacts. We’re in the business of selling product, not of speculating on currencies.”

CEOs want to be able to tell investors that their risk is under control, and to assure them that foreign currency movements will not unexpectedly affect profitability and EPS. The only way to control risk is to, first, clearly see it and, second, efficiently manage it. The ability of corporate treasurers and FX risk managers to do so will become even more critical in the months to come, because this environment of global uncertainly will not change anytime soon. The euro remains in crisis, while other risks loom: consider the New Zealand and Australian dollars, and the ongoing worries surrounding the Chinese renminbi. The U.S. dollar also recently hit a 15-year low against the yen, the results of which will show in third-quarter results.

Global uncertainty aside, sharp currency moves are not the issue—it is how companies are or are not managing through those moves. A clear divide exists between companies with less volatile earnings and those with higher volatility—the former use sophisticated techniques to manage FX exposures, the latter do not. "[Foreign exchange] is something that [companies] don't typically focus on until it reaches up and bites them," Peter Sorrentino, a portfolio manager at Huntington Asset Advisors recently told Bloomberg.

To manage predictability on earnings, to avoid being bitten, and to become one of the stand-out, good news stories that the press ogles in upcoming quarters, corporate treasury managers should follow the steps of past volatility survivors and winners.

Big or small, be proactive, not reactive, in managing currency risk. After all, that's how Google turned (and continues to turn) analysts' heads. It is surprising how many companies with vast global operations still assess exposures after quarter-end and use that information to adjust next period's hedges. By then, it's often too late. And company size does not matter. Percentage-wise, FX exposure impacts a $200M revenue company just as much as it does a $30B revenue company. The only company free from the burden of managing the impact of FX on EPS is a large company that, theoretically, can absorb FX hits better than can most. However, as one assistant corporate treasurer sagely noted, "I don't know any shareholders like that."

Know your data. Be nimble, ready for quick turns in currency rates. It's also surprising how many companies still assess exposure based on spreadsheets that trickle in from offices around the globe over a two, three, four, or more week period. The resulting calculations, this late in the game, already represent old news, sometimes resembling nothing close to a firm's current exposure. Google hedged the euro literally the day before it crashed in early May because of its systematized, automated, and nimble process that allows Treasury to access real-time exposure data daily or, for the paranoid, even more frequently.

Similarly, Agilent has created a full-circle, straight-through FX management process that runs from Oracle to Misys and SunGard Integrity and back again—a process that saves time and gives Treasury the ability to see and manage exposure at any time. The job of FX Risk Management Practitioners, to do FX right, is to blaze unique, new trails or to follow known success examples.

When it comes to exposure, say NO to "swags"—be confident in your numbers. "A lack of confidence in your numbers should be a red flag for any leader or organization," said one director of corporate treasury. "And confidence in the exposure data and FX remeasurement process is an absolute necessity to properly manage risk." The fact is: we don't know what we don't know. It might take significant preliminary analysis and investigation to identify gaps before corporate treasury managers can take corrective and pre-emptive action. "We really didn't know what we were missing," said one VP and treasurer for a major telecom, after a confidence-building exploration revealed that his company had been missing 30 percent of exposures. Since then, the compay has also managed to avoid $2.8 million in losses over two quarters.

Tap the science. As the Wall Street Journal and other publications have noted of late, successfully managing FX risk is part art, part science. To help manage risk most effectively, corporate treasury managers should first take advantage of the science—and then perfect the art. Google wasn't jostled by the recent currency flux not only because they can see and understand their exposure in minutes instead of weeks, but also because they rely on technology, rules and algorithms and resulting decision-support tools that give Treasury the ability to quickly analyze and visualize the impact of various hedging strategies. Roll up those hedges? Clear those I/C accounts? Because the impacts of such decisions stretch far, it's wise to take advantage of existing science to peer into the future.

Think of Treasury as the strategic partner it is. Consider how much value Treasury could add to the business if only it would flex its muscle. Agilent's Treasury team, armed with enhanced data, is pursuing several strategic projects, including the evaluation of alternate hedging instruments, that will boost the firm's bottom line. "The business moves. The business changes. And that's as it should be," explained Dawnette Blake, FX & pensions manager for Agilient. "We don't want Treasury to be a stumbling block in reaching the overall strategic goals of Agilent. Our goal is to support the overall business."

Elizabeth St-Onge, Managing Director of Treasury Strategies agrees. "Historically, Treasury evaluated its success by its ability to remain invisible. That has fundamentally changed. Successful treasury departments today are highly visible and highly strategic," she explained.

Realize that achieving 70 or 80 percent hedge coverage may not be enough. At first glance, 80 percent hedge coverage looks like successful risk reduction. However, as one large consulting organization with coverage greater than that discovered, even 80+ percent may not represent a firm's true exposure, either due to under- or over-hedging, or because the 20 percent of remaining exposure lies in highly volatile, non-G10 currencies.

Currency, at best, is unpredictable. And it will continue to be so. The key is being able to quickly find out how that unpredictability is affecting your currencies around the world, and then acting just as quickly to mitigate risk. If a CEO and CFO can't respond succinctly and quickly as to how they are managing FX risk, analysts will expect surprises and discount accordingly. After all, summarizes one corporate treasury practitioner, "The bottom line is to reduce volatility."