ANZ Investment Bank

Tendering Case Study: Overlooking FX Exposures can be costly.

Small to Medium Businesses can often overlook the foreign exchange rate risks associated with foreign currency exposures. Currency volatility can be underestimated, as it is not always seen as one of the primary risks. The impact of overlooking foreign currency exposures, by not hedging, can have a significant negative effect on profits.

This article will highlight the impact that foreign exchange fluctuations can have on the profit margins of a company. It will also look at how these risks can be mitigated through the use of foreign currency hedging products.

In order to demonstrate these foreign exchange risks, we will use a recent small business experience involving a tender.

The company in question was tendering for a local contract. All of the components for the tender were being imported and those costs were payable in USD. The company submitted their tender, which incorporated the cost of purchasing the USD. They would be notified in three months time if they were successful. They had no recourse to amend the contract cost for exchange rate fluctuations.

This is a situation faced by many small to medium sized businesses in Australia everyday. Superficially the effect of the foreign exchange risk to the business may not appear to be of paramount importance. However when we take a closer look at the numbers, we can show that the risk is actually relatively significant.

Total Tender price AUD 500,000

Net Profit margin	10%
Profit	AUD 50,000

USD Import Component

Cost	USD 100,000
Exchange rate	0.5500
Budgeted cost	AUD 181,818

Average AUD/USD quarterly moves: 550 cents

Potential value at risk approx.: AUD 20,200

When we take a look at the actual numbers involved we can see that there is a potential for 40% (or higher) of the profit margin to be eroded by currency fluctuations. It would be prudent for a conservative business, at the very least, to consider this possibility and the effect that this may have on fundamental cash flow. In this instance the small business believed that the potential risk associated with currency fluctuations was great enough to require the implementation of a hedge. This process will now be outlined.

The initial foreign exchange risk that this business encountered was the need to manage the currency risk associated with the tender period. As the company would not be notified for 3 months as to whether they would be successful or not, it was decided the outright purchase of a vanilla AUD Put option would be the most suitable hedge. The purchase of a vanilla option gave this business the right but not the obligation to sell AUD at the budgeted rate of 0.5500 for a future date. A few scenarios were possible at expiry.

Firstly, if the company was unsuccessful their only cost would be the premium associated with the purchase of the option. In this instance the amount was approximately AUD 2,500. The cost would only be applicable if the option expired worthless or out of the money (i.e. if the spot market was greater than 0.5500 at expiry). If in fact the option expired in the money then the business would be able to close out of the option and take a financial gain. This would be used to offset the premium cost.

Secondly, if the company was successful in winning the tender then they would be protected at the budgeted level of 0.5500 and also have the potential to participate in any gains above this level.

In this case the company was successful and the prevailing market rate for AUD/USD was above the budgeted level and therefore they let their option lapse. They were then able to enter the spot market to implement a hedge to cover their now certain currency exposure.

As the purchase of the USD denominated components was now certain, the company decided to enter into a forward exchange contract (FEC) for 50% of the face value and a vanilla AUD Put for the remaining 50% of their currency exposure for a period of 4 months. The FEC rate was 0.5515. This was transacted at a spot rate of 0.5575 adjusted by the forward premium of 60 points. This was above their budgeted level of 0.5500. This company also decided that the purchase of a vanilla AUD Put for the balance of 50%, at the budgeted rate of 0.5500, would provide them with a degree of flexibility, which they believed to be important. The cost of this option (approximately AUD 2,000) was accounted for during the budgeting process and as such was embedded into the cost of the overall contract.

At expiry date, the current market rate for AUD/USD was 0.5300. The company delivered under their FEC (at 0.5515) and exercised their AUD Put option at 0.5500. Their effective exchange rate was 0.55075, which was above their initial budgeted level.

This paper has outlined only some of the risks associated with foreign currency exposures. If you are a Small to Medium business and you would like further information on foreign currency hedging products, please contact the ANZ FX SMB team at our email address: fxsmall@anz.com or call Brian Marnell, Head of SMB ANZ Global Foreign Exchange , 1800 688 581

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