LOOKING BEHIND THE HEDGE AT AUD EXPOSURES

Long-time corporate treasury and risk management professional **Ivan St Clair*** looks back over three decades of untethered Australian dollar and wonders if Corporate Australia is really using currency hedging to best effect.

December this year will see the 30-year anniversary of the floating of the Australian dollar. During those 30 years, many corporations have developed, and continued to refine, their foreign exchange hedging policies with the main objective of managing financial risk.

It's useful now to consider how well those hedging policies have served Australian corporations.

A theoretical base

A good deal of modern academic literature concerning the theory for the financial policies of companies has referred to the propositions of Modligiani and Miller (M&M). In essence, they proposed that a company's value is unaffected by financial policies (assuming no taxes, no transaction costs and fixed investments) as investors can create their own risk profiles by undertaking hedging in their own right.

According to M&M, the value created by hedging must be based on a tax advantage, reducing transaction costs, or improving investment decisions. It should be noted that the premise that investors are actively creating their own risk profiles is problematic as:

- investors have varying degrees of financial sophistication and resources;
- investors generally do not have access to sufficient company information to hedge effectively; and
- there is little evidence to support investors creating their own risk profiles.

Hedging in practice

Hedging policies are generally considered to contribute towards the value of the business by reducing volatility in cash flow, profit and/or the balance sheet (ie. instead of, financial volatility). The specific areas where value is added can be considered under the following headings:

1. Financing benefits: Lower financial volatility can lead to a higher share price, the potential for higher gearing and/or cheaper financing.

2. Extending the mean time to financial distress: Hedging provides protection against severe market movements that may negatively impact committed transactions to the extent that the corporation suffers financial distress. Hedging creates time to restructure the business model.

3. Reducing the potential for competitive disadvantage: Corporations often monitor the hedging policies and activities of their competitors to determine if they can either develop a competitive advantage through their pricing and/or hedging activities; or at least, ensure that they don't create a competitive disadvantage by being "too different" from their competitors in their approach to hedging

4. Reducing the cost of doing business: Lower financial volatility should also generate value for suppliers and customers.

Less risk to suppliers should provide favourable trading terms and customers should place a higher value on post-sales support. However measuring the "added value" in these areas is problematic.

It's generally acknowledged that hedging is not about trying to profit from movements in currencies. Many companies tried this in the early to mid eighties only to find that they could not out-perform the market.

The cost of hedging

Forward exchange rates are calculated by adjusting the spot exchange rate by the forward points. The forward points represent the difference in the interest rates of the two currencies involved over the forward term.

Since 1993, Australian interest rates have usually been higher than US interest rates, which means that the forward points have usually been negative (refer Fig 2). Importers have paid the cost of the forward points when hedging and exporters received the benefit of the forward points when hedging.

We would not be surprised therefore, that importers generally kept their hedging time-frame comparatively short – usually just sufficient to hedge their committed orders. Exporters in the resources sector tended to have longer dated exposures, and received the value of the forward points, therefore they tended to hedge over longer time-frames.

Hedging policies changed in 2000

Around the turn of this century, a number of Australia's large resource companies (including BHP Billiton, WMC Resources and Woodside) changed their currency hedging policies from hedging (in some cases out to two to three years) to not hedging at all. Their reasons included:

FIG 1 – AUD/USD SPOT RATE 1993 – 2013

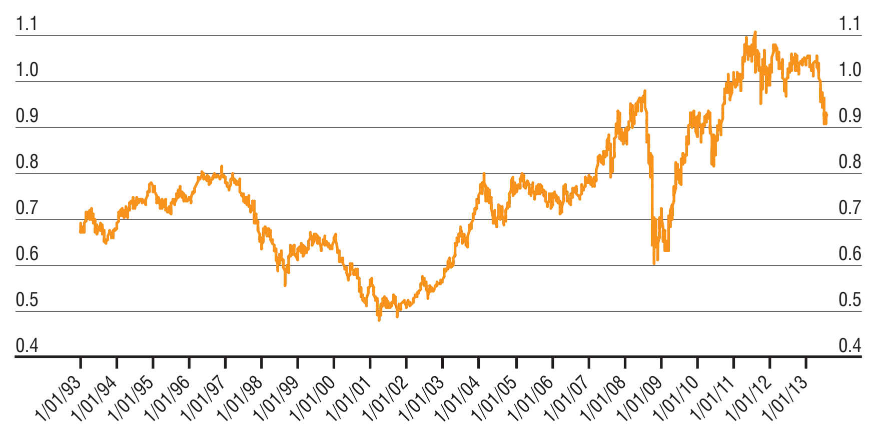
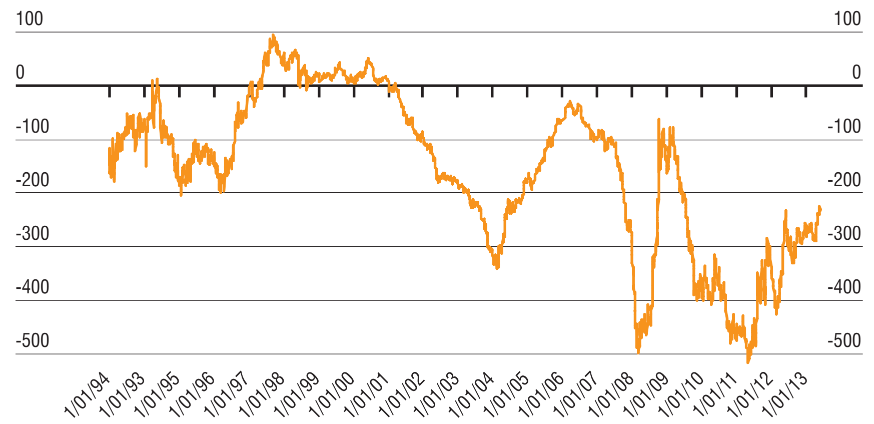


FIG 2 – AUD/USD 12 MONTH FWD POINTS 1993 – 2013



Source: Treasury Training Pty Ltd

- portfolio diversification made currency risk less important;
- the relationship between the AUD and commodity prices reduced risk;
- the corporation was large enough to withstand adverse currency movements;
- the corporation would use USD as its functional currency; and
- shareholders expected currency exposure.

It may be coincidence that, from around 2000, the exporting companies that had been hedging (and receiving the value of the forward points) had to explain large hedging losses because the AUD had depreciated substantially (see Fig 1) and they were no longer receiving the value of the forward points (see Fig 2) through hedging.

Within two years some market commentators noted the potential issues with abandoning currency hedging. In February 2004, the high-profile commentator Terry McCrann wrote "Australia's resources sector is presiding over a multi-billion dollar foreign exchange disaster that makes the NAB's losses look like petty cash" and "… a calculating decision by boards and managements that while you can and will be hung out to dry by the things that you do do, you can't and largely won't be held to account for things – hedging – that you don't do."

Shareholder value added or destroyed?

We noted earlier that hedging is not about trying to profit from movements in currencies – and we should accept that we're unable to consistently predict currency movements.

Therefore it's unfair to criticise resource companies for not predicting the general appreciation in the AUD over the last 13 years. However the question remains as to whether resource companies should be trying to create some value through the forward points by hedging at least a portion of their AUD exposures.

To estimate the potential value lost by not hedging export receipts into AUD we have estimated the average 12 month forward points from 2000 to date as minus 195 and estimated the average USD-AUD exchange rate over the same period as 0.7597.

For the AUD exposure that may have been hedged for 12 months but wasn't, the corporation has lost 2.6 per cent each year.

In any one year, that's worth having. Over 13 years that adds up to a substantial amount – and it has nothing to do with which way the currency moved.

Risk management or value creation?

For importers who are paying the forward points, hedging is only about risk management at the lowest cost. For exporters receiving the forward points, hedging should be a combination of risk management and value creation – without getting too greedy.

So are there any exporters out there practicing risk management and getting some value back through the forward points?

Yes – have a look through the Wesfarmers Limited 2012 Annual Report, which states:

"The Group aims to hedge approximately 45 per cent to 55 per cent (over five years) of its foreign currency sales for which firm commitments or highly probable forecast transactions existed at the balance sheet date. The current hedge contracts extend out to June 2017. Such foreign currency purchases arise predominantly in the Resources division.

"The Group aims to hedge approximately 70 per cent to 100 per cent of its non-capital expenditure related foreign currency purchases for which firm commitments or highly probable forecast transactions exist, up to 12 months forward."

But in relation to exporters that have stuck with the "conventional wisdom" of not hedging, the last 13 years may have resulted in a significant opportunity cost.

Maybe Terry McCrann's comments were well-founded after all. AB+F

HIGH LEVEL VIEW

ABOUT THE AUTHOR

Ivan has been involved in the finance industry for over 40 years, specialising in treasury, corporate finance and financial risk management for the last 28 years.

Ivan is a former partner at Ernst & Young where he was responsible for the firm's Australian corporate treasury advisory group for nine years. He has also completed a short-term assignment as the interim chief financial officer of Centro Properties Group, securing extensions to its financing facilities and so enabling the appointment of a permanent CFO; he has also assisted in a refinancing of several other major companies, PaperlinX and Nufarm among them.

He is currently providing financing and financial risk management advisory services and running treasury training courses.

The next treasury training course is on 18-20 September. Ivan can be contacted on 0411 475 833 and ivan.stclair@treasurytraining.com.au