MANAGING CURRENCY EXCHANGE RISK IN TODAY'S ENVIRONMENT

The purpose of this information capsule is to provide Canadian exporters with the essential steps and tools to implement a strategy to hedge currency risk.

The volatility of the Canadian dollar can have a significant impact on Canadian companies' foreign earnings. Many exporters, for example, ĐĉĞč suffered from the appreciation of the Canadian dollar between 2000 and 2008, during which time the U.S. dollar lost more than 60% of its value against the loonie. More recently, and particularly since Donald Trump took office, the Canadian dollar has experienced significant volatility against the greenback due to rising U.S. protectionism, which threatens the growth of economic activity in several export-related sectors in Canada.

IS YOUR BUSINESS EXPOSED TO CURRENCY RISK?

To find out, it is advisable to define the three main risks inherent in exchange rate fluctuation: **Transaction risk**, the most important risk to consider, concerns present or future payables and receivables denominated in foreign currencies. For a Canadian exporter to the United States, the risk is that a depreciation of the U.S. dollar will reduce its profit margin recorded in Canadian dollars. **Currency conversion (or balance sheet) risk** is related to the value of the company's assets. For example, a Canadian company with a subsidiary in France is exposed to the risk of depreciation of the euro. **Economic currency risk,** on the other hand, refers to the loss of competitiveness of a Canadian company in the United States vis-à-vis its American competitors following an appreciation of the loonie.

Let's look at the particular case of transaction risk. It is advisable to determine when this risk may occur. Generally, it appears well before the time when the currencies are converted. For example, if your company issues a price list at the beginning of each fiscal year (or season), the exchange risk may arise several months before you bill the customer. On the other hand, if prices are negotiated contract by contract, as is often the case, then the risk is much easier to manage, because your company can predict future cash flows with greater certainty.

WHY AND HOW TO IMPLEMENT A CURRENCY HEDGING STRATEGY

The primary purpose of a foreign exchange hedging strategy is to protect the company's profit margins from adverse fluctuations in the Canadian dollar. An appropriate hedging strategy eliminates the uncertainty associated with currency volatility and ultimately allows you to focus on what matters most: the core business of the company. The objective is to protect your company's profit structure, so that it no longer has to anticipate the dollar's fluctuations. Here are the three main steps required to implement a hedging strategy:

1. **Evaluate your conversion needs and assess your exposure to currency risk.**
   There are several factors to consider when developing a strategy tailored to your needs, such as the budgeted rate, net amount to be covered, sales history, accounts receivable and seasonality.

2. **Choose the hedging strategy that suits you best.**
   One of our risk management specialists can help you define your exposure to currency fluctuations by identifying three key elements:
   a. Term: how long do you need coverage?
   b. Ratio: what percentage of your accounts receivable should be covered?
   c. Instruments: which instruments are best suited to your company's situation and objectives?

3. **Implement a risk management policy and regularly review your needs.**

There are numerous instruments and product combinations at your disposal. Here are two examples of instruments frequently used by Canadian companies to hedge against currency risk:

Forward contracts allow you to set the amount and rate used to convert your currencies at a later date. The forward conversion rate is equal to the prevailing spot rate, adjusted for the difference in interest rates between Canada and the United States.

Collars allow you to protect your U.S. dollar income from potential depreciation, while allowing you to benefit in part from a rate movement in your favour.

Every company is in a unique situation and deserves a diagnosis and recommendations tailored to its needs. Whether you are a client of Laurentian Bank or not, you can benefit from the services of a foreign exchange specialist who offers you customized protection tools and advice adapted to your needs.

› **Currency risk management consulting services**
  » Personalized analysis of your currency risk exposure
  » Assistance with implementing a risk management policy
  » Direct access to a foreign exchange specialist

› **Buying and selling foreign currencies**
  » Regular monitoring of your needs
  » Risk hedging strategies

› **Daily foreign exchange market review**

If you have any questions, please make an appointment today with one of our foreign exchange specialists at fx@blcmf.com or 514-350-2910.

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