currencywave
SMARTER GLOBAL PAYMENTS

Looking to reduce currency risk?

Simple hedging techniques explained.

+44 (0) 113 451 0180 • info@currencywave.com
www.currencywave.com

Forward currency transactions for businesses

Do you take unknown risks with your company's foreign exchange (FX) exposure and hope for better outcomes or would you prefer to protect your bottom line?

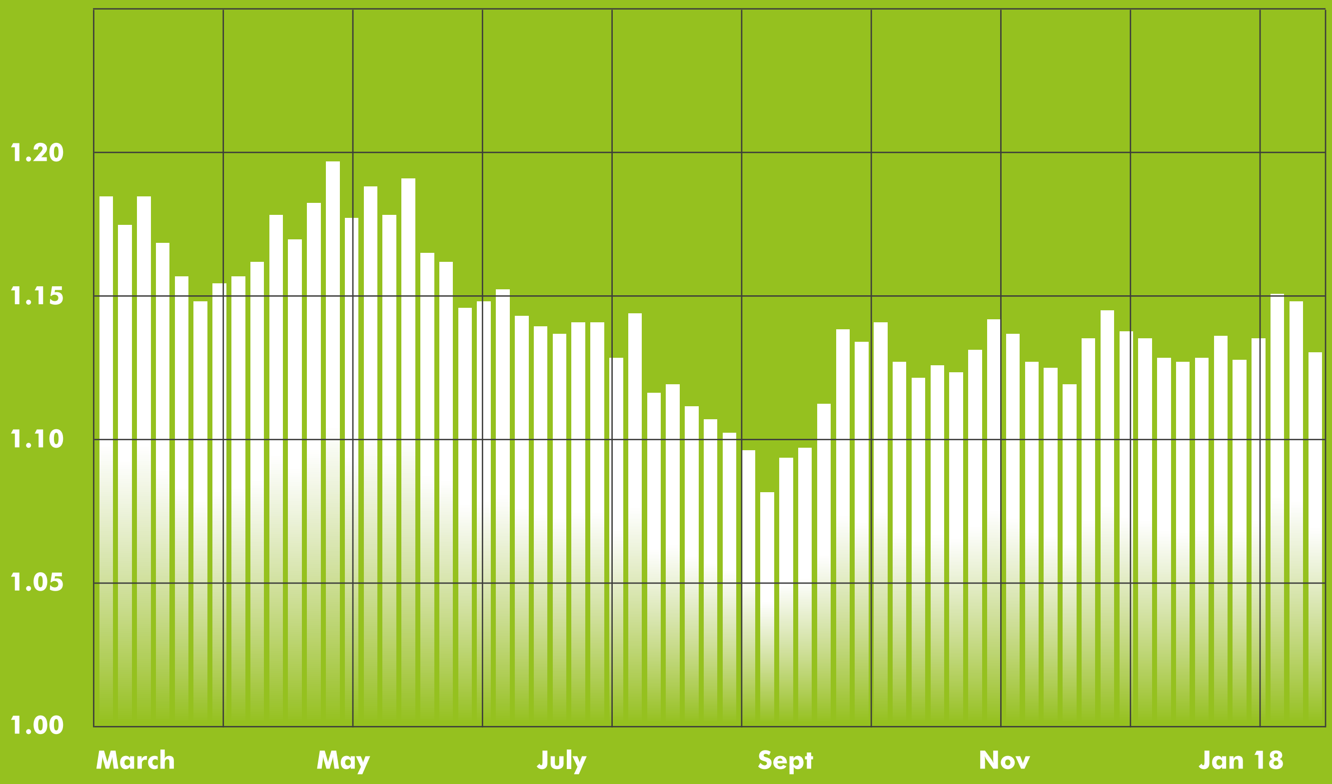
If you are an importer or exporter of raw materials, goods or services then it is likely that you are exposed to the risk of currency volatility. Typically, there will be a time lag between establishing a contract denominated in a foreign currency and the eventual payment of that contract. Within this time period currency fluctuations can make a substantial difference to the amount received or paid under the contract and, if not addressed, this can threaten your profit margins.

Driven by macro-economic influences which are beyond the control of companies, currency fluctuations are very unpredictable and can have a substantial effect on the performance of your business.

The chart below of GBP to EUR illustrates just how much currencies can move, even over relatively short periods of time:

GBP to EUR Chart

7 Feb 2017 00:00 UTC - 7 Feb 2018 14:55 UTC **GBP/EUR** close: **1.12874** low: **1.07964** high: **1.1**



Assessing the risk

Large multinational companies employ 'hedging' strategies to mitigate currency risks, continually assessing their FX exposures and taking action accordingly. For small and medium sized businesses, they often neither have the time, knowledge or even access to hedging facilities in order to deal with this problem. Moreover, some companies take the view that currency movements will even themselves out over the course of the year but any sudden financial shocks in the economy can create undue currency volatility and unforeseen risk.

It is therefore important that these risks are identified in order that their potential impact on profitability can be assessed and dealt with accordingly.

So, what is currency 'hedging'?

The definition of financial 'hedging' is: 'a means of protecting oneself against financial loss or other adverse circumstances'. Not to be confused with hedge funds, who business it is to speculate on financial markets, currency hedging for commercial purposes seeks to create neither an FX profit or loss but to maintain the status quo and remove risk from the business. Hedging need not be difficult or complicated and if used correctly can be an effective instrument for protection against the volatility of future currency movements.

One of the most effective ways of achieving this protection is through a 'forward currency contract'. This gives you the certainty of fixing the amount you will receive or pay on a transaction thereby allowing you to protect your profit margin. They are an invaluable tool for dealing with the uncertainties of currency fluctuations and should form part of your foreign exchange risk strategy.

What is a forward currency contract?

Generally, the price of a currency pair (e.g. GBP/EUR) is commonly quoted as a 'spot' exchange rate where payment for the currency being purchased is due straight away.

A forward currency contract on the other hand, is an agreement to buy or sell a specific amount of currency at a fixed exchange rate where settlement is not due until sometime in the future (up to 1 year usually). The forward exchange rate may include a premium or discount from the spot exchange rate which is based on the interest rate differential between the countries of the two currencies, calculated over the length of the contract. If the country of the currency being purchased has higher interest rates than the currency being sold then the forward price will contain a premium over the spot price and vice versa.

It is usual for the buyer of the forward contract to place a small deposit with the broker (normally 5%) and then pay the balance when the contract is due to settle.

As the forward exchange rate is fixed for the length of the contract, this gives the holder certainty as to the value of future currency cash flows.

Exporting Example

Acme Widgets Ltd makes a sale worth EUR 100,000 to a customer based in Germany and produces an invoice contracted on 60-day payment terms. At the point the sale contract is struck, the GBP/EUR spot exchange rate is 1.1236, which would equate to a GBP sale worth £88,999.64 (EUR 100,000/1.12360).

Between the date of the contract and the eventual payment by the customer 60 days later, there are three possible outcomes; the exchange rate remains the same, GBP rises against EUR or GBP falls against EUR.

An analysis of the latter two outcomes is described below:

GBP rises against EUR:

60 days after the contract is struck, Acme Widgets Ltd receives EUR 100,000 from the customer and converts it into GBP. At this point, the GBP/EUR exchange rate has risen 2% to 1.14607 and Acme receives £87,254.70 into their account (EUR 100,000/1.14607).

Result

Due to the exchange rate moving against it, Acme receives £1,744.94 less than it had expected on the sale.

GBP/EUR Exchange rate ↑

GBP falls against EUR:

60 days after the contract is struck, Acme Widgets Ltd receives EUR 100,000 from the customer and converts it into GBP. At this point, the GBP/EUR exchange rate has fallen 2% to 1.10112 and Acme receives £90,816.62 into their account (EUR 100,000/1.10112).

Result

Due to the exchange rate moving in its favour, Acme receives £1,816.98 more than it had expected on the sale.

GBP/EUR Exchange rate ↓

As can be seen from the above example, currency movements can create gains or losses in the company's books despite not being any part of company's core business. They distort the company's real performance and although there may be favourable outcomes on occasion, it is impossible to predict their direction.

It is therefore advisable to lock in or 'hedge' the currency position by purchasing a forward currency contract as illustrated below:

Although Acme will no longer benefit if the exchange rate moves in its favour, it now has a more robust business model for crystallising the profit on its overseas sale. Using forward exchange rates improves the predictability of cash flow forecasting and helps companies budget far more accurately.

Forward currency contracts can also be used to hedge the cost of importing raw materials, goods or services.

Example

NewTech Ltd outsources some of its IT services to a contractor based in Poland and agrees an annual contract costing 600,000 Polish Zloty (PLN) to be paid monthly in arrears over the course of the year. With a current spot GBP/PLN exchange rate of 4.7577, the total cost of the contract is equivalent to £126,111.36 (PLN 600,000/4.7577). As NewTech cannot afford to buy all of the required Zloty outright, it buys PLN 50,000 every month as each payment becomes due.

Over the course of the year the GBP/PLN exchange rate could remain roughly the same, but more likely it will fluctuate up and down and thus have an effect on the cost of the contract to NewTech. Two illustrative outcomes are discussed below:

GBP rises against PLN

Over the course of the year, the average spot exchange rate achieved by NewTech on the monthly Zloty purchases is 4.9955, which represents a 5% rise since the contract was agreed.

Result

Due to the exchange rate moving in its favour, the resultant cost to NewTech is now £120,108.10 (600,000/4.9955), a saving of £6,003.26 from the original price.

GBP/PLN Exchange rate ↑

GBP falls against PLN

Over the course of the year, the average spot exchange rate achieved by NewTech on the monthly Zloty purchases is 4.5198, which represents a 5% fall since the contract was agreed.

Result

Due to the exchange rate moving against it, the resultant cost to NewTech is now £132,749.24 (600000/4.5198), which is £6,637.88 more than the original price.

GBP/PLN Exchange rate ↓

In order to remove currency risk, NewTech could instead decide to hedge the total cost by taking out 12 separate forward currency contracts at the outset of the agreement:

AMOUNT OF CURRENCY	SETTLEMENT DATE	FORWARD EXCHANGE RATE	GBP COST
PLN 50,000	1 month's time	4.7611	£10,501.77
PLN 50,000	2 month's time	4.7647	£10,493.84
PLN 50,000	3 month's time	4.7669	£10,489.00
PLN 50,000	4 month's time	4.7693	£10,483.72
PLN 50,000	5 month's time	4.7722	£10,477.35
PLN 50,000	6 month's time	4.7748	£10,471.64
PLN 50,000	7 month's time	4.7777	£10,465.29
PLN 50,000	8 month's time	4.7804	£10,459.38
PLN 50,000	9 month's time	4.7831	£10,453.47
PLN 50,000	10 month's time	4.7823	£10,455.22
PLN 50,000	11 month's time	4.7881	£10,442.56
PLN 50,000	12 month's time	4.7905	£10,437.32
		TOTAL COST	**£125,630.56**

The 12 forward currency contracts have staggered settlement dates to match each monthly Zloty payment as they fall due. As each monthly payment now has at a fixed forward exchange rate, NewTech knows in advance exactly how much it is going to pay over the full course of the agreement. With their future liabilities now fully hedged, NewTech is no longer exposed to currency movements and can budget ahead with more certainty.

Flexibility of Forward Currency Contracts

Forward currency contracts provided by CurrencyWave are a highly flexible tool designed to meet the dynamic requirements of small and medium sized businesses. Sometimes customers do not pay their invoices on time or delays occur in the completion of supply agreements so this can have cash flow implications on any ongoing forward currency contracts.

Supposing Acme's customer in the previous example is late in paying the invoice and settles 70 days after the contract date rather than the agreed 60 days. In this instance, Acme has the flexibility to 'roll over' or extend the settlement date of the forward contract to coincide with the delayed cash receipt date.

Early drawdown of currency before the forward settlement date is also possible, should the need arise. This can be useful where the timing of future currency receipts or payments is less certain. The company can hedge with just one forward currency contract over a set period which it can drawdown, as and when required.

Forward currency transactions for individuals

Looking to buy or sell an overseas property, yacht, car, antique etc?

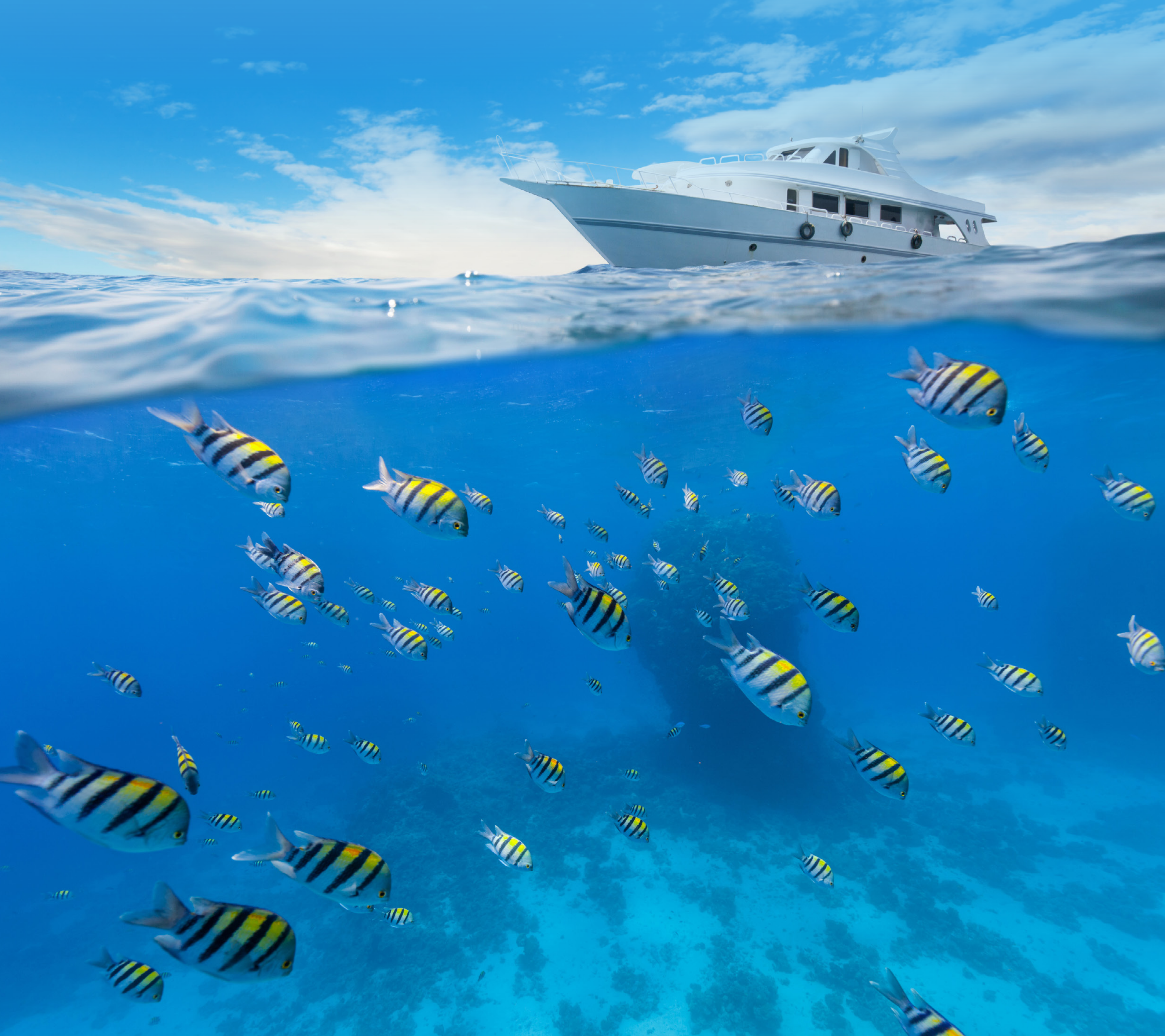
Forward currency contracts can be a useful tool for individuals who may be dealing with a large currency conversion such as the purchase/sale of an overseas property, yacht, car, antique etc. Where there is an expected delay before the payment is due, it can be advisable to lock in or hedge the exchange rate to reduce the risk of currency loss.

Example

Mr Smart buys a property in Florida for USD $600,000 and expects to make payment 6 months later once contracts have been exchanged. At the time he agrees on a price with the vendor, the spot exchange rate for GBP/USD was 1.3841 which is the equivalent of £433,494.68 (USD $600,000 / 1.3841).

Supposing the GBP/USD exchange rate has fallen to 1.3271 when Mr Smart comes to convert his money to pay for the property 6 months later. At this exchange rate he will now be paying £452,113.63 (USD $600,000 / 1.3271) for the property which is a whopping £18,618.95 more than he had anticipated.

Rather than leaving the exchange rate to chance, Mr Smart could fix the cost of the property at the outset by arranging a forward currency contract to buy USD $600,000 for settlement in 6 months' time. He could take out a forward GBP/USD contract at an exchange rate of 1.3946, which costs £430,230.89 (USD $600,000/1.3946). His property purchase price is now locked in giving him peace of mind knowing he is no longer at risk from adverse currency movements.



Other currency management tools

To save you time tracking currency movements, you can instruct CurrencyWave to execute a currency transaction at a set target exchange rate in one of two ways:

Limit Orders

If you have a target exchange rate in mind you can instruct us to execute your currency transaction automatically when this target is reached. We will monitor the exchange rate on your behalf leaving you to concentrate on running your business.

Stop Loss Orders

As the name implies, a stop loss order is designed to prevent further losses should the exchange rate deteriorate beyond a specified level. If the exchange rate worsens to your pre-determined target, we will automatically execute the currency transaction on your behalf.

100% Secure

Our payments partner, Currency Cloud, is backed by Google Ventures (GV) satisfying the due diligence requirements of one of the largest companies in the world in their first European investment into the growing FinTech sector.

Our systems are robust, secure and above all regulated by the UK regulator - the Financial Conduct Authority (FCA). All client funds are held in a segregated bank account with Barclays Bank plc meaning they are ring fenced from the assets of the firm in the unlikely event of default.

Physical Security Our service operates from multiple high security Tier 4 Data Centres used by banks and other financial institutions.

Data Security We are certified under ISO/IEC 27001:2013, the international best practice standard for information security management

About CurrencyWave

CurrencyWave is at the forefront of FinTech innovation, providing access to better-than bank currency exchange rates and frictionless international payment services for companies and individuals.

Our payments engine offers superior speed of execution with real time exchange rates at a fraction of the cost charged by the banks.

We support over 35 currencies and 212 country destinations.

Real time confirmations
Pre-saved beneficiaries

Bank Beating Exchange Rates
Save up to 85% on hidden bank charges

Fast and reliable payments
No transfer fees

Payment provider
Regulated by the Financial Conduct Authority (FCA)

Over £12bn processed per year
20,000 payments sent per day

Currency risk management
Spot & forward rates available

Payment services for CurrencyWave are provided by The Currency Cloud Limited which is regulated and authorised in the UK by the Financial Conduct Authority (FCA) under the Electronic Money Regulations 2011 and the Payment Services Regulations for the issuing of electronic money and the provision of payment services with FCA registration number 900199.

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SMARTER GLOBAL PAYMENTS

6b Joseph's Well, Hanover Walk, Leeds, LS3 1AB, United Kingdom

T. Enquiries: **+44 (0) 113 451 0180**

E. **info@currencywave.com**

www.currencywave.com