Rating options

Foreign currency options could help timber importers dealing with unfavourable exchange rates. Adrian Sutherland, head of corporate sales at currency broker World First, explains

UK import companies have been experiencing trying times recently, with tightening credit lines and a drop-off in consumer demand leading to tough trading conditions. The weakness of sterling has only compounded the situation.

The sterling to dollar exchange rate has fallen by 25% over the past 12 months and the sterling to euro rate by 27% over the past two years. With the UK economy deep in recession, a new UK Budget with no help for small to medium-sized businesses and the banks offering little support, almost all companies in the UK are facing a serious business challenge.

And no-one is feeling this impact quite as severely as importers. Unfavourable fluctuations in currency inevitably increase overheads for importers. Add to that the worst recession since the second world war and importers are being hit from both directions with rising costs and reduced demand. The end result? A shrinking bottom line.

Currency risk management is reserved by the banks for their largest clients and businesses may be getting even less support than normal from their bankers at the moment. So where can an international business go for help? In the past 20 years an industry of currency brokers has developed in the UK specialising in currency exchange and international payments.

These brokers will typically offer forward contracts on currency to help companies protect against adverse exchange rate moves. But the problem with forward contracts is that they don't provide any flexibility and, with rates at historic lows, many companies are currently wary of locking into long-term forward contracts.

However, foreign currency options bring together the best of both worlds. They provide a guaranteed worst case rate, like a forward contract, but also the potential of a better rate if the exchange rate improves. There are a variety of different option structures available depending on your specific circumstances and your appetite for risk.

I'll use a couple of fictional business scenarios to illustrate different currency options. In the first, Animport Ltd imports from the Far East, paying its suppliers in US dollars and budgeting at a rate of 1.45. It opted for a currency option called a convertible forward which gave a worst case rate of 1.45 but allowed the company to benefit if the rate improved, up to 1.60. If at the end of each month the sterling/dollar exchange rate is below 1.45 it will get 1.45, guaranteeing Animport's budget rate. If it is above 1.45 Animport is allowed to take advantage of the improved rate. If the rate touches 1.60 during the month, however, the company reverts back to a worst case rate of 1.45.

At our second business, Timber Imports Ltd, the financial director wanted to manage the company's exposure to the euro. However, he was worried that sterling may rise against the euro so did not want to lock into a forward contract. He decided to buy a currency option called a participating forward, which guaranteed a worst case rate slightly lower than the forward contract rate. At the time, the forward rate was 1.10 but instead Timber Imports Ltd bought a participating forward with a worst case rate of 1.07. If the rate is below 1.07 at the end of the contract, the company can buy the €100,000 it needed at 1.07. If the rate is higher, Timber Imports Ltd will buy €50,000 at 1.07 and €50,000 at the higher rate, giving a higher overall average rate.

It's important that importers take action to protect their company from the risk created by the current global economic crisis. Through currency options, small to medium-sized businesses can get the protection of a guaranteed rate if markets worsen, and the flexibility of benefiting from improving currency rates. Simply put, almost any company with a currency turnover between £1m and £250m could benefit.

Currency risk management specialists can also provide tailor-made risk strategies adapted to each client's currency needs. Any importer worried about their exposure to currency fluctuations should know what services and products are available. They can then make an informed decision based on best practice currency risk management in an uncertain environment. ■

SUMMARY

- **The weakening pound has had a severe impact on UK importers.**
- **The sterling to dollar rate has fallen by 25% over the past 12 months; sterling to euro by 27% over two years.**
- **Forward contracts on currency don't offer any flexibility.**
- **Foreign currency options offer a variety of structures.**

World First offers an FSA-regulated currency risk management service to firms moving £1m or more per year

Sterling's 12-month fall against the dollar and euro