

Whenever a company or an individual enters into an agreement to trade in goods or services that are priced in a foreign currency, there is immediate exposure to risk in the volatile foreign exchange market. Bob Brown, marketing & sales director at UK-based Capital Currencies Ltd., offers some advice on avoiding the pitfalls.

Foreign currency—managing the risk

Foreign exchange rates in the market change by the second and fluctuate to an unpredictable degree both in the short- and long-term. Different currencies will also fluctuate to varying degrees depending on the market forces at play both nationally and internationally. For example, last year if you had wanted to buy US dollars, the variation between the best and the worst exchange rate was 15% and for the South African rand it was 45%. Such variations can mean the difference between a profit and a loss.

How does a company that is buying or selling abroad manage the risk and safeguard its income and/or profit margin?

Example: Company A contracts to sell shoes into the Far East at a price of \$25,000, for delivery and payment in three months time. At the time of the agreement, the USD/GBP rate was 1.76 but at the time of payment it had risen to 1.9 and reduced income by £15,000.

How can an individual buying a foreign property ensure they do not have to pay substantially more than was budgeted for when completion takes place weeks or months later?

Example: A man agrees to buy a new-build manufacturing facility abroad at a price of €300,000 when the euro/GBP exchange rate is 1.46. On completion, nine months later, it has moved to 1.39 which increases the cost of the property by £10,000.

So, for both businesses and individuals, obtaining the exchange rate that is assumed when agreeing a contract must

be the prime objective in managing foreign currency requirements.

Solutions

There are a number of ways a company or individual can reduce or even eliminate the risk.

With a *Forward Trade* contract you can order and reserve currency at a fixed exchange rate in advance of an agreed date when you will need the money. Generally, a small deposit is required upfront, with the balance being paid on the agreed delivery date.

Example: Another company agrees to buy services from a US supplier at a price of \$175,000, for payment in four months time and, simultaneously, enters into a forward trade contract at the prevailing exchange rate of 1.95. Thus, when payment is due, the company is guaranteed a rate of 1.95, irrespective of the actual market rate and the budgeted income (and profit margin) is therefore protected.

However, it is not always possible to accurately predict the future date when the currency will be needed. For example, knowing when invoice payments are likely to be received is not an exact science. In this situation, an *Open Forward Trade* contract may be better as it offers the right to take currency at any time during an agreed future period, rather than at a specified date as with a forward trade contract.

Example: A tanner orders hides from Germany at a fixed price of €120,000 for delivery in five to six months and contracts for an open forward trade at the prevailing

euro/GBP exchange rate. By so doing, he sensibly protects his bank balance by guaranteeing the exchange rate when he has to make the future payment for his hides.

However, there are occasions when foreign currency is needed within a shorter timescale but the prevailing exchange rates are unacceptable. In this situation, and particularly if the market seems to be moving in a positive direction, a *Limit Order* can be used to track the rates until the target rate is reached, when the currency will be purchased.

Example: A production problem requires a company to buy one million machine components from the Far East at short notice. The unit price is \$1 and an exchange rate of 1.90 or better is needed to meet the production cost budget. Unfortunately, the prevailing rate is 1.86. However, by using a limit order, the \$1 million is purchased automatically when the market hits the target level of USD/GBP 1.90.

On the other hand, if the market is moving in a negative direction, a *Stop Order* can be activated when the exchange rate falls to the lowest acceptable level to protect against a sustained fall.

A chemical company ships materials to South Africa and receives regular payment into its South African rand account. On receipt, the funds are repatriated automatically to GBP only when the exchange rate is better than the stop order level of ZAR/GBP 12.

Effective foreign currency management means safeguarding margins, protecting profits and ensuring peace of mind. 🌐

While the mechanisms and services mentioned in this article are recognised within the financial market, the degree to which they are used will depend upon the foreign currency supplier. Companies such as Capital Currencies offer them to individuals and businesses wherever they may be in the world on the assumption that there are no restrictions to the unhindered movement of money internationally imposed by the government of the country concerned. Clients must also register with the service supplier in order to satisfy the requirements of current money laundering regulations before any business may be transacted.