Risk and Response:

How hedging techniques can help SMEs rise to the forex challenge

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For even the most astute of CFOs at Singapore's SMEs, there is one critical issue beyond their immediate control: the volatility of exchange rates.

By and large, SMEs enjoy the significant benefits of this country's open economy – but for those doing business globally there's a constant currency risk; in fact, 31 % of businesses cite fluctuating exchange rate as a major concern. Some, no doubt, have learned hard lessons of the past when a development like Brexit or an unexpected move by the Federal Reserve were sudden forex game-changers.

If, for example, you look at remittances involving the US Dollar, which accounts for roughly 60% of all FX volumes traded by SMEs in Singapore, you will see a trading range of approximately 11% over the last 12 months – from a high of 1.4545 to a low of 1.3110 most recently. With import and export volumes making up around S$300 billion annually, FX volatility is a real – and constant - concern for many local businesses.

Understanding your risk...

For many Singapore SMEs, forex risk is exacerbated by small revenues and tight cash flows.

Wholesale trading and manufacturing are two typical industries in Singapore that are import-heavy and often trading on thin margins. In some cases they also export goods - possibly dealing in several different currencies - and hence, have no natural hedge.

This adds additional layers of complexity for many SMEs and creates factors that simply cannot be overlooked or, worse, gambled on. Currency fluctuations can diminish margin overnight and they are difficult to budget for. But they're not impossible to manage – at least not for companies agile in their thinking and open to new ways of doing business.

The first step should be for a company to assess its level of exposure, remembering that while a particular business may not seem to be significantly exposed, there could be further risk down the line through its customers and suppliers. Once you are aware of where all your forex vulnerabilities lie it becomes easier to plan or prepare for currency fluctuations.

One non-hedging approach is to insist on buying or selling only in Singapore dollars, though this carries the risk that competitors might be willing to work with their foreign customers and vendors by transacting in their local currency.

So the reality for most SMEs is that it is the application of one or more hedging techniques that significantly reduces the risk and the ongoing angst of potential major forex fluctuations.

Choosing your response...

The American Express FX International Payments team has supported SMEs in Singapore with their currency needs for many years. We help our clients assess and implement hedging strategies that best suit their needs.

There are many options available in mitigating forex risk and most SME directors and finance managers doing business internationally are aware of – or possibly have suffered from – adverse movements in exchange rates; but if managing that exposure is not a core skill, then it probably makes sense to speak to a specialist who can help the business in protecting those precious margins.

1

The **forward contract** is the most commonplace and straightforward hedging tool as it sets exchange rates for an agreed future date, say in 90 days if you have 90 days credit from a supplier. This allows SME's to lock in their profit margins and mitigate potential losses from adverse movements in exchange rates.

Forward contracts also allow SMEs to average out forex cost over time when forecasting what their expected currency requirements will be - typically over a 3, 6 or 12-month timeframe. They then purchase forwards in order to manage a portion or all of these anticipated volumes.

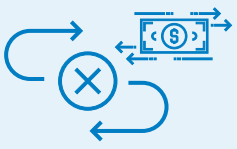
2

Limit orders give a client the ability to purchase a currency once it hits a pre-set level. They can hold appeal for clients who may be bullish on the movement of a currency and wish to take advantage of volatility which could improve profit margins. At a more basic level, however, they suit businesses which don't typically have time to be constantly tracking currency movements during the working day but still seek the opportunity to capture favorable rate movements.

3

A **stop loss order** works in a similar way to limit orders; however, they are used where there is an expectation that the value of a currency will depreciate and, hence, help to mitigate the risk of losses a business can suffer from such a forex movement. To that end they can be placed to cover a client position both throughout the day and during overnight trading.

4



A combination of limit orders and stop loss order, is an **OCO (One Cancels the Other)** which dictates that when either the limit order or stop loss order is triggered then the unfulfilled order is automatically cancelled. An OCO can be useful during periods of volatility and when an SME has concerns about an upcoming payment – to be made or received - where, for example, the margins may be fine. The OCO offers upside potential whilst capping downside risk.

5

Finally, one of the simplest techniques for managing FX risk – is to open a **foreign currency account** in order to balance foreign currency receipts against foreign currency expenditure. For example, opening a Euro account allows you to receive and send EUR payments without the need for foreign currency conversion; if this is feasible then it effectively takes currency movement out of play.