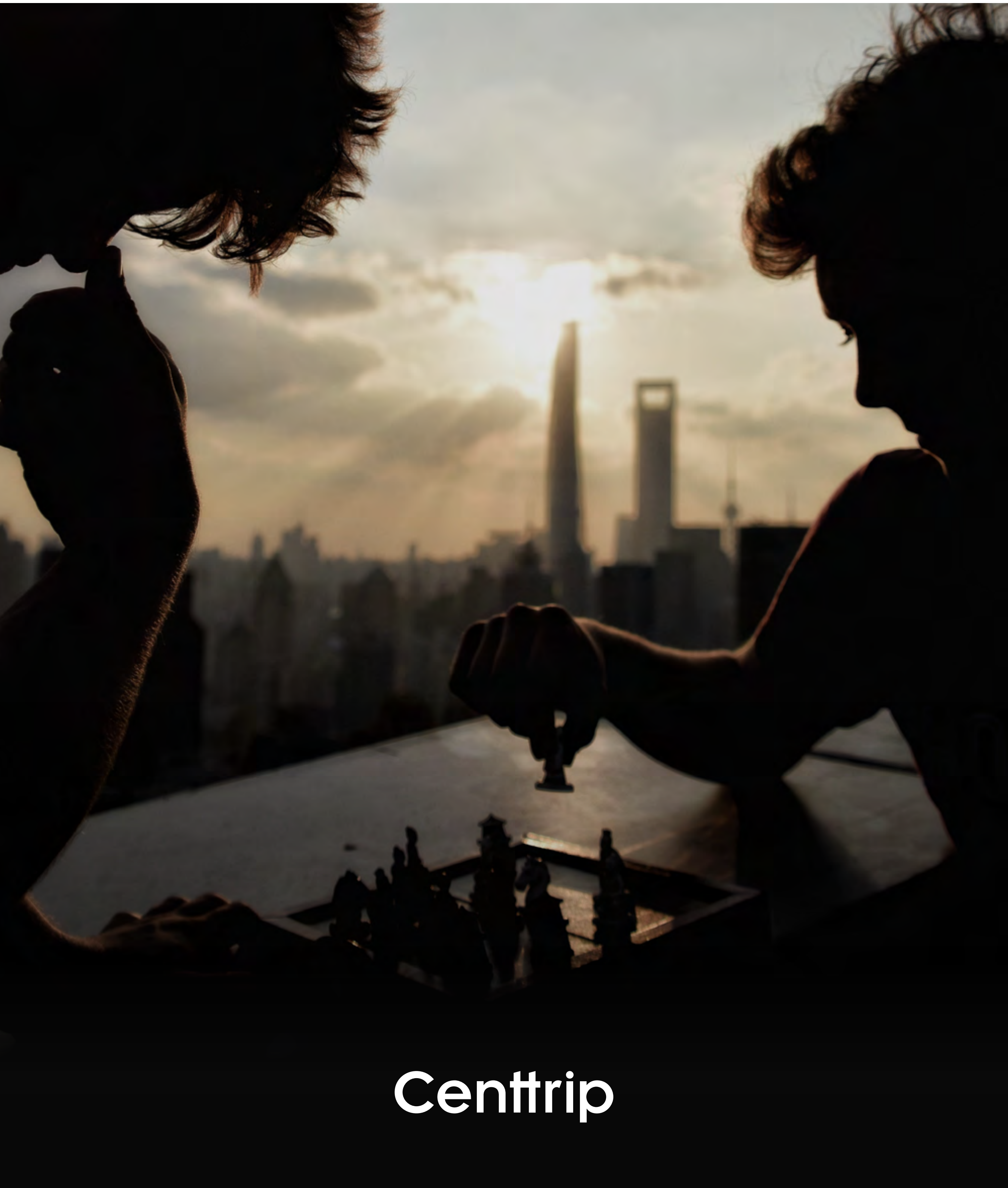
Centtrip Guide

How to Develop Your Currency Strategy



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Foreword

If ever a year highlighted the need to plan for the unexpected, it was 2020.

While some sectors, such as live music, travel and hospitality, faced enormous disruption, others, like technology, experienced a boom. As Microsoft's Satya Nadella put it, "We've seen two years' worth of digital transformation in two months."

In a turbulent year, currencies soared and plunged. On 13th December 2019, following the UK's general election, the GBP/USD exchange rate spiked at 1.34751. Three months later, with the Covid-19 lockdown, it plunged to 1.14926 – a massive 15% from its December peak.

Yet, as we write, in early January 2021, the rate is in the 1.36 range.

No one knows the future but, in the past year, we've seen more clients seeking to mitigate their exposure to currency risk. So much so that we've increased the size of our currency desk team.

Clients are, perhaps, taking the view that to do nothing is an even greater risk. Whereas, armed with insights and tools, they can develop a strategy that helps them face the future with at least some degree of certainty.

We have created this Centtrip Guide to Currency Strategy to help organisations begin to develop those strategies.

At Centtrip, we work with internationally mobile clients in many sectors and we greatly appreciate their business. We look forward to supporting them as they develop and deliver their plans for 2021.

Jane Turner, CEO, Centtrip

Managing foreign exchange risk

We insure our cars and homes, our business assets and our key people, so why not our international cashflows?

How much do exchange rate movements a ect your business? Possibly, more than you imagine. In the last year, the GBP/USD rate has moved almost 20%.

Movements of that scale can have a serious impact on your business.

If a substantial part of your revenue comes in US dollars, then you might be receiving fewer pounds sterling than you expected.

Alternatively, if some of your costs are in dollars, then you're paying fewer pounds for the same products or services.

In either case – bad news or good – that's a lot of uncertainty to have in your cashflow.

But, what can be done? Some businesses simply take it on the chin, viewing foreign exchange (FX) rate movements as a cost of doing business. But, is that the best approach?

Maybe a better question is: can you afford that level of risk? What would a 15% movement in your core exchange rate do to your overall profit?

Other businesses take a more considered approach, understanding the potential effect and taking steps to mitigate the risk where appropriate.

In this Centtrip Guide to Currency Strategy, we look at why you might want a currency strategy for your business and how to begin creating one.

"We process more than £16 million a year in foreign currency payments using Centtrip. If we save 2.5% on every transaction, that's equivalent to £400,000 per year."

Jay Rutland, Creative Director, Maddox Gallery

Currency risk and why you might need a strategy

It can be more of a gamble to do nothing.

There are many reasons why you might wish to consider a currency strategy but, ultimately, it all comes down to risk and uncertainty.

Most businesses with foreign income or costs have the same pain-points:

- Foreign exchange movements negatively affecting profits
- Lack of clear understanding of the business's exposure to FX movements
- Lack of a clear strategy to manage FX risk to an acceptable degree.

These pain-points arise from three types of foreign exchange risk.

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1. Transaction risk

When a business has international revenue or costs, or if it agrees the international sale or purchase of an asset, there is a risk that the FX rate will change between the order/sale and settlement.

For example, on 1st January a UK-based singer agrees to perform at a US festival on 1st July for a fee of $100,000. At the time of the contract, the exchange rate is 1.25 GBP/USD, representing an income of £80,000.

On 1st July, when the fee falls due, the rate has increased to 1.33. The artist receives $100,000 but this is now equivalent to only £75,188, 6% less than originally expected.

2. Translation risk

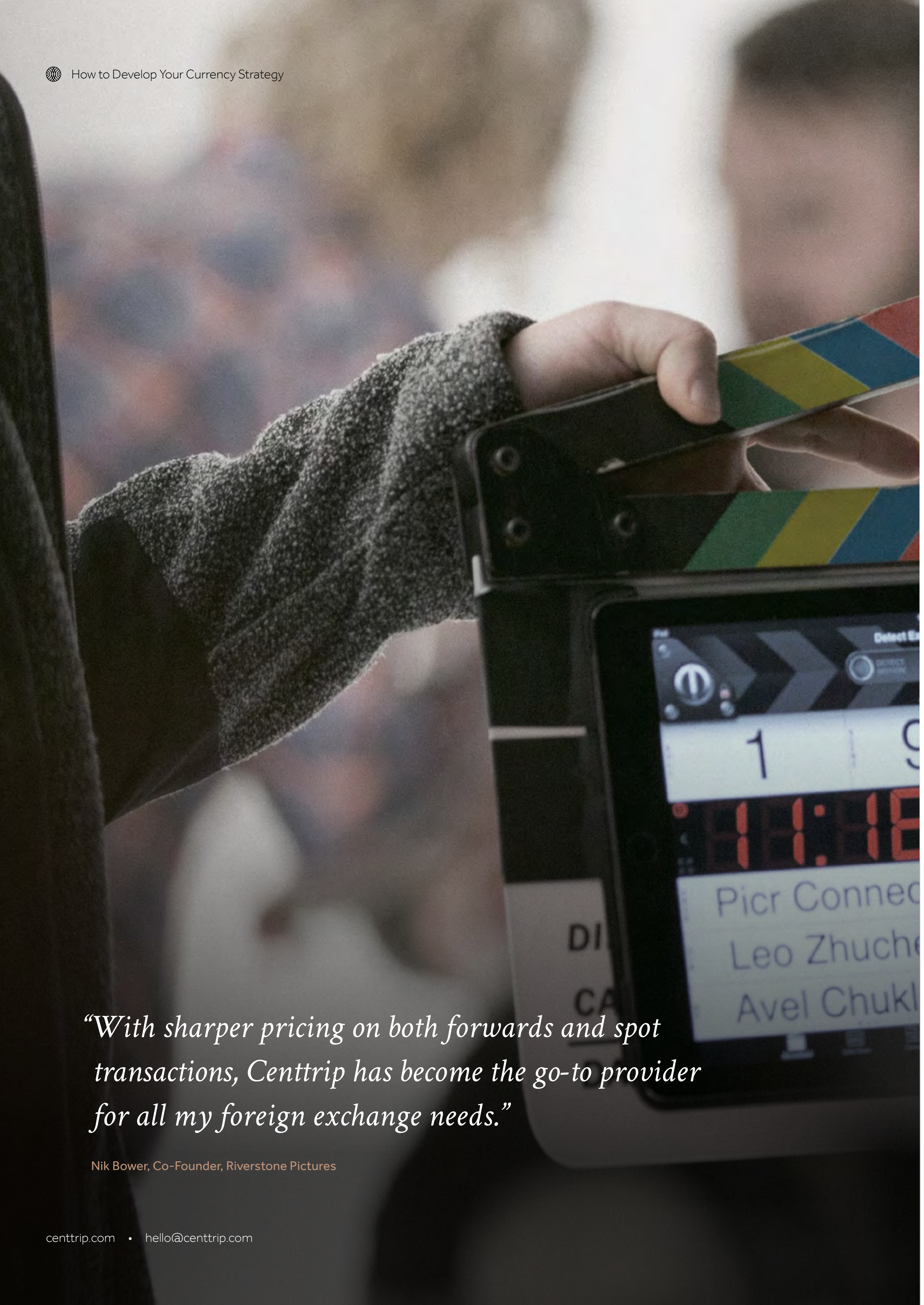
International businesses may have assets in different countries, denominated in different currencies. Translation, or conversion, risk represents the fact that the consolidated value of an international business will change with FX fluctuations.

For example, a UK-based family office may hold a yacht in a Monaco subsidiary. Over the course of a year, net charter income, in euros, may have improved by 5%, from €20 million to €21 million. However, if the GBP/EUR rate has moved by 10%, from 1.10 GBP/EUR to 1.21 GBP/EUR then the income recognised in the UK accounts will have fallen from £18.2 million to £17.3 million, a decrease of 4.5%. The yacht's value on the GBP-denominated balance sheet will have been similarly affected.

3. Economic risk

Economic, or operating, risk describes the longer-term, effect of exchange rate movements on a business's competitive position.

For example, in the early 2000s, many western firms invested in manufacturing plants in lower-cost Eastern Europe. As those economies have become stronger, their currencies have strengthened, eroding some of the cost advantages of the original offshoring decision.



"With sharper pricing on both forwards and spot transactions, Centtrip has become the go-to provider for all my foreign exchange needs."

Nik Bower, Co-Founder, Riverstone Pictures

Creating a Currency Strategy

Currency strategy and risk management

Most currency strategy is concerned with the relatively short-term issue of managing transaction risk.

Whether you need to lock a single transaction (an asset sale or investment inflow, for example) or manage an operating cash flow, it's worth creating a currency strategy.

Example: The potential for unseen loss during the sales cycle

A UK-based film production company agrees to rent a French chateau for a film shoot at a price of €100,000, when the GBP/EUR rate is 1.20 (a cost from its production budget of £83,333).

The chateau's management company raises the invoice, for €100,000, one month in advance of the shoot, when the rate is 1.05 (a cost that will enter the UK company's books at £95,238).

The invoice is due for payment in 30 days, by which time the rate has moved to 1.10. The company pays (€100,000 / 1.10 =) £90,909. The difference between invoice and payment values of (£95,238 - £90,909 =) £4,329 is recorded as a "gain" on foreign exchange in the production company's P&L account.

The difference between what the company expected to pay, and originally allocated out of its budget, (£83,333) and what it eventually paid (£90,909) doesn't appear in the company's accounts. However, it's an important, if invisible, cost because the production has had to find an additional £7,576 against its original expectation. At best, that's a big chunk out of its contingency budget. At worst, it means cuts somewhere else in the production.

Some businesses have a policy of hedging their currency risk at the point of invoice, but that does nothing to mitigate the unseen loss (or risk of loss) between making the commitment to spend and receiving the bill A better policy is to address the transaction risk at the point the commitment is made.

Better still, would be a strategy that recognised in advance that international expenses would be incurred and sought to mitigate the risk before any commitment was made.
That is the purpose of currency strategy.

1 | Understand how currency affects your business

Understand your budget rate

Your budget rate is the FX rate you chose when you wrote your annual budget (or project plan). Some businesses treat it as almost inconsequential – "We've used the same rate as last year." – but it can have an enormous impact. Choosing the wrong rate can lead to poor decision-making, uncompetitive pricing and unexpected losses. Choosing a budget rate requires careful consideration. Factors to take into account include:

Profit margins
Narrow margins on imported or exported goods or services make the budget rate choice more critical because the business is more exposed to movements in the real, market rate.

Pricing cycle
Some businesses set their prices for the year, others review regularly. The longer the period between reviews, the greater the risk that exchange rates move against you.

Sales cycle
The period between agreeing a sale and collecting payment on an invoice can be a period of FX risk and often unseen loss.

"We use Centtrip for all our international payments and touring expenses management, saving us significant time and money. And with direct access to live markets we are no longer subjected to any hidden fees."

Ian McAndrew, Wildlife Entertainment (Arctic Monkeys)

Measure the size of your exposure

What are your plans for the coming year?

The starting point for developing a risk mitigation strategy is to understand the risk. Look at your expected cash inflows and outflows on a per-currency basis. Think about the points in time when foreign payments are received or paid out.

For example, you may receive royalties in US dollars which are paid to you on a quarterly basis, or you may settle a regular bill for jet fuel in dollars on the 20th of every month. Perhaps you place a regular order for stock from China, cash on order, every two weeks.

Think about your operational practices. Do you operate foreign currency accounts, netting off receipts and payments and only repatriating funds every quarter?

This will give you a view of your business's exposure to currency movements over time. It might look something like this:

	Jan	Feb	Mar	Apr	May	Jun
USD infl w from foreign income	500	500	550	600	600	750
USD outfl ws for expenses	-950	100	100	100	100	100
Net USD cashfl w	-450	600	650	700	700	850

Create some sensitivity analyses

How sensitive is your profit ma gin to currency fluc uations?

Now you have a base-line view of your currency exposure, it's a good idea to create some alternative scenarios to demonstrate the currency risk to your business.

For example, re-run your model to see what would happen if the exchange rate moved from your budgeted or forecasted rate by +/- 1%, 5%, 10%. Crucially, also work out your breakeven exchange rate.

You may have budgeted at GBP/USD = 1.25, but at what rate does your P&L tip from profit to loss? If you're creating your analysis on an Excel spreadsheet, the Goal Seek function is an easy way to find your breakeven exchange rate.

How far is the breakeven rate from the current market rate? That is an important measure of your business risk.

2 Assess your attitude and appetite for risk

Understanding your business exposure to currency risk is important, but this needs to work hand-in-hand with your organisation's attitude to, and appetite for, risk.

Attitude to risk

Some organisations are risk-averse, others are recklessly buccaneering. Some prefer to insure against every, non-core risk so they can concentrate fully on the business. Others will roll with fate and deal with the consequences as they arise.

Understanding your organisation's attitude to risk will help you create an appropriate strategy.

Understanding the extent of your currency exposure, in terms of both magnitude and the gap between your breakeven exchange rate and the market, can also colour your attitude to currency risk. A relatively small exposure with a large margin of safety might suggest a looser strategy than you would choose if a substantial proportion of your profit is at risk from a small market movement.

Appetite for risk

Some organisations are risk-Defining appetite for risk is the next step. It involves articulating your attitude and appropriate boundaries for currency risk, in other words: how much risk is your business prepared to bear?

A UK-based company, for example, might decide to accept an exposure to USD costs of up to $1 million per year, but to limit any further exposure using forward contracts.

Some situations can be one-sided. For example, once a film production budget is signed off and underwritten by a production bond, any potential gain from foreign exchange is of limited benefit. At that stage, as film producer Steve Jarvis of Parkhouse Pictures says, "you can't make a better movie" with any unexpected gains. A loss, however, can have serious consequences. If the agreed foreign funding doesn't translate into the required local currency, the production is faced with making last-minute cuts to its budget. In these situations, the organisation might have a very small appetite for risk and seek to protect a potential downside as much as possible.

Possible methods for expressing appetite for risk include:

- Profit and cashflow measures, such as acceptable level of annual loss
- Limits or targets for key indicators, for example +/- 5% variation in revenue, +/- 2% in product cost, etc.

As you begin to think about your currency strategy, start with a clear and quantified articulation of your organisation's attitude to, and appetite for risk.

Make sure that it's measurable, so you can review performance and fitness for purpose.

Also, ensure you actively review attitude and appetite, regularly. These will change with economic circumstances, with changes in organisational strategy and with changes in senior management.

If you would like to read more on developing risk management policies, the Association of Corporate Treasurers recently published its Guidance for Producing Treasury Policies, which is available as a free download here.

3 Develop an appropriate strategy

With an understanding of your exposure over time and your organisational approach to risk, you can begin to develop an appropriate currency strategy by considering your goals and the tools available to meet those goals.

What are your currency goals?

Do you wish to protect your business from only the most extreme movements in FX rates, or do you need to eliminate as much risk as possible?

Perhaps there are particular projects or budget lines that need protecting while you're prepared to accept market risk on other operating lines.

One Centtrip client, for example, is a UK-based technology company engaged in a joint-venture development project with a US business. The US partner pays an agreed US dollar amount each quarter to fund research work carried out in the UK. The UK firm's objective was to secure the US cashflow so that it could plan its work according to a known GBP amount. With known dates and USD amounts, it was able to create a strategy to fix its GBP receipts using a series of forward contracts.

What is the exchange rate forecast?

Comparing your currency needs and goals against the current (spot) rate is of limited value. You really need to compare against where the market will be when you need it. Your foreign exchange partner or bank are probably the best source for exchange rate forecasts. You can often find partial forecasts online, but reliable forecast information is not nearly as easy to find as spot-rate analysis.

With a good currency forecast, you should be able to determine the points of highest risk to your business.

If you work with a professional currency desk, they will also be able to advise on important dates that may influence your strategy. Examples include reporting dates from central banks which can introduce unwanted volatility. Whatever the outcome of a monetary policy announcement, you may prefer simply to avoid possible turmoil by bringing your planned transaction forward by a week.

Consider the available tools

Managing foreign currency risk isn't necessarily complicated. For discrete overseas projects, for example, the answer may be as simple as using a foreign currency or multi-currency account.

The most common tools beyond using simple deposit accounts are to buy currency now – at live market, or spot, rates – for future use, or to use a currency forward contract (usually referred to simply as a forward) to "order" currency for a future date at an agreed rate.

If the current exchange rate seems favourable, and you have the cash available, you may decide to buy US dollars now, at the spot rate, even though you don't need to pay the money out until a later date.

Working with forwards

Forward trades are an important tool for hedging currency risk and they are often used by international businesses.

A forward is simply a contract to buy or sell a given amount of currency at a fixed rate on a given future date. Using a forward, you can lock in the exchange rate you will pay at the future date, removing the risk that rates will move against you in the meantime.

One of the main attractions is that they are completely flexible – you can create a forward to meet your precise needs, for example $107,550 in 57 days.

The main determinants of price for a forward is the time-value of money and the interest rate differential between the two currencies involved. Apart from this, they typically cost around the same as a spot-rate exchange transaction.

Example: A 12-month GBP/USD forward

If we assume that the current, spot, rate for GBP/USD is $1.3000 per £1, the interest rate for US dollars is 2.0% and the UK interest rate for GBP is 1.0%, then:

Currently: $1.3000 = £1.0000

In 12 months' time: $1.30 plus 2.0% interest will equal £1.00 plus 1.0% interest

=> $1.30 x (1 + 0.02) = £1.00 x (1 + 0.01)

=> $1.3260 = £1.0100

=> (1.3260 / 1.0100 =) $1.3129 = £1.0000

So, the 12-month forward rate is: GBP = USD1.3129

"We locked our rate at 1.125 and the actual rate ended up being 1.17, a movement of 4-5%. Without hedging, we would have had a shortfall of £130,000 to £140,000."

Steve Jarvis, Film Producer and Co-Owner, Parkhouse Pictures

The pros and cons of forward contracts

Advantages

- ✓ Allows the business to lock-in an exchange rate for a future transaction
- ✓ Enables management of cashflows without worrying about FX volatility
- ✓ Can contribute a degree of certainty and risk mitigation to protect a budgeted FX rate

Disadvantages

- ✕ Risk that the rate moves the other way, rendering the contract loss-making
- ✕ A deposit is sometimes required at commencement

Working with a currency partner

Many organisations choose to work with a currency dealing desk as an extension of their treasury or finance teams. This gives them access to market knowledge and expertise "on demand" as they plan and execute a currency strategy.

Engaging with a partner early in your budgeting process, or project planning, can help you embed currency strategy into your operational processes and to plan for likely hedging requirements.

Professional currency dealers can also advise on policies such as regular international payment dates or target rates. For example, is a nice, round rate like 1.30 really in your best interests, or would a less psychologically appealing rate like 1.295 produce a better outcome?

Building a partnership means that the currency desk becomes familiar with your business model, your currency requirements and your appetite for risk which enables them to become a more proactive contributor to your currency strategy.

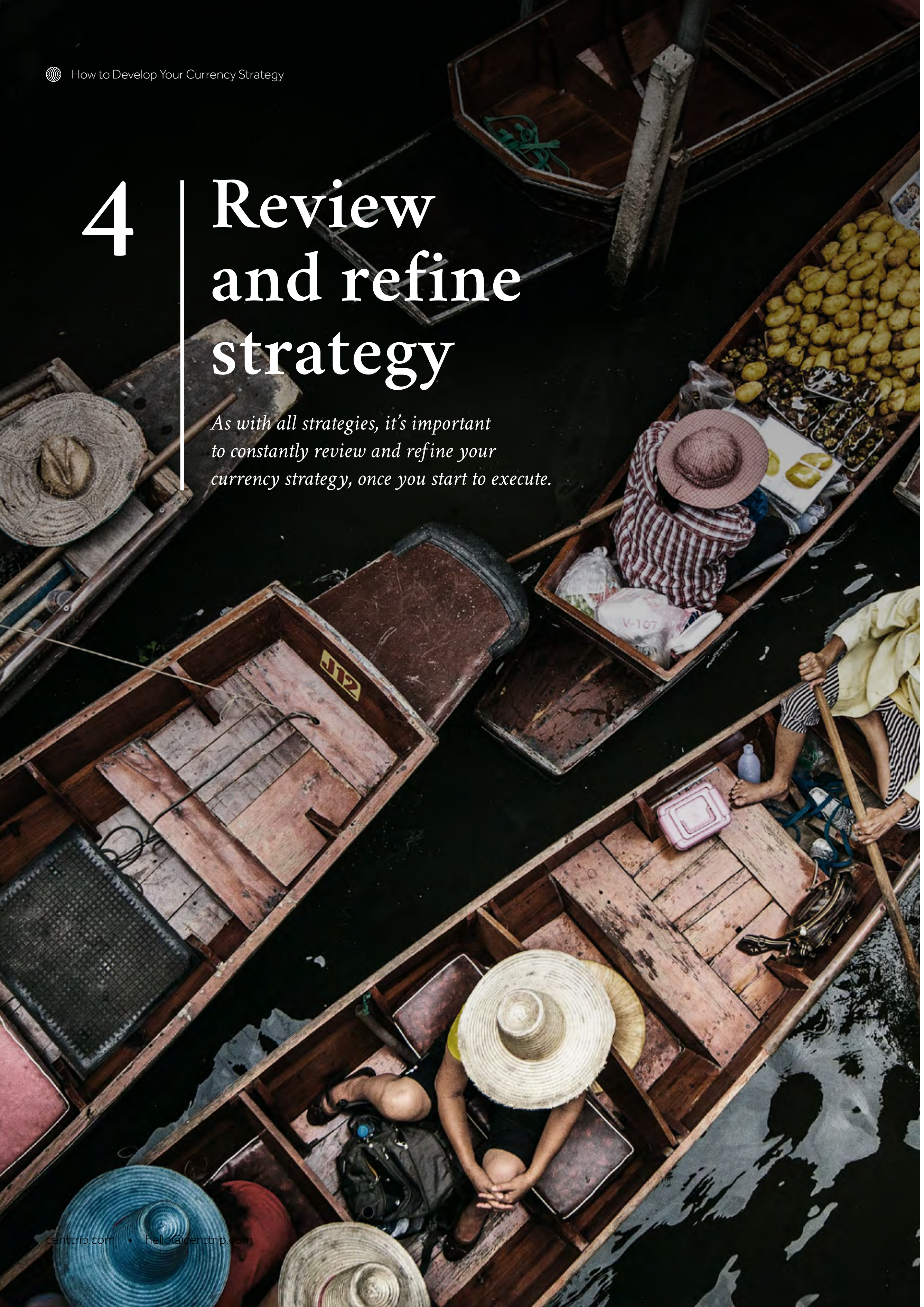
Emergency provisions

Over the past decade, the world has seen some sudden economic shocks that had a dramatic effect on exchange rates.

During March 2020, and the shock of Covid-19, the GBP/USD rate moved by 12.4%.

In June 2016, and the Brexit vote, the GBP/USD rate dropped by 11.1%.

As you create your operational currency strategy, make sure you include procedures for what to do in an emergency. These could be financial or operational, such as having a contingency source of supply if the price of your usual imports increases dramatically.



4 Review and refine strategy

As with all strategies, it's important to constantly review and refine your currency strategy, once you start to execute.

Things to consider:

- Does the strategy still align with your organisation's attitude to and appetite for risk? How do actual outcomes to date align with your quantified appetite for risk?
- Does the strategy still meet the needs of the organisation in light of possible changes in:
  - Business strategy
  - Market conditions
  - Leadership changes?
- How do actual outcomes compare with what might have happened without a strategy? For example, how would the transaction or cashflow at actual market rates have compared to the forwards you put in place?
- Which tactics worked and which didn't?

As you review, consider what needs refining. Does your strategy need to become more cautious, or slightly looser? What new opportunities or challenges have arisen?

"Many producers wouldn't think about currency hedging. They'd be so busy, with their heads down, trying to get their film made. But, if you're getting your finance in a foreign currency it should be top of your list. Thinking ahead and working with currency experts like Centtrip, you can save yourself a lot of heartache and aggro."

Steve Jarvis, Film Producer and Co-Owner, Parkhouse Pictures

Currency terms and tools

Like any other profession, the world of foreign exchange and currency has its own language. Here are a few key terms and tools that it's helpful to know as you speak with your currency partner.

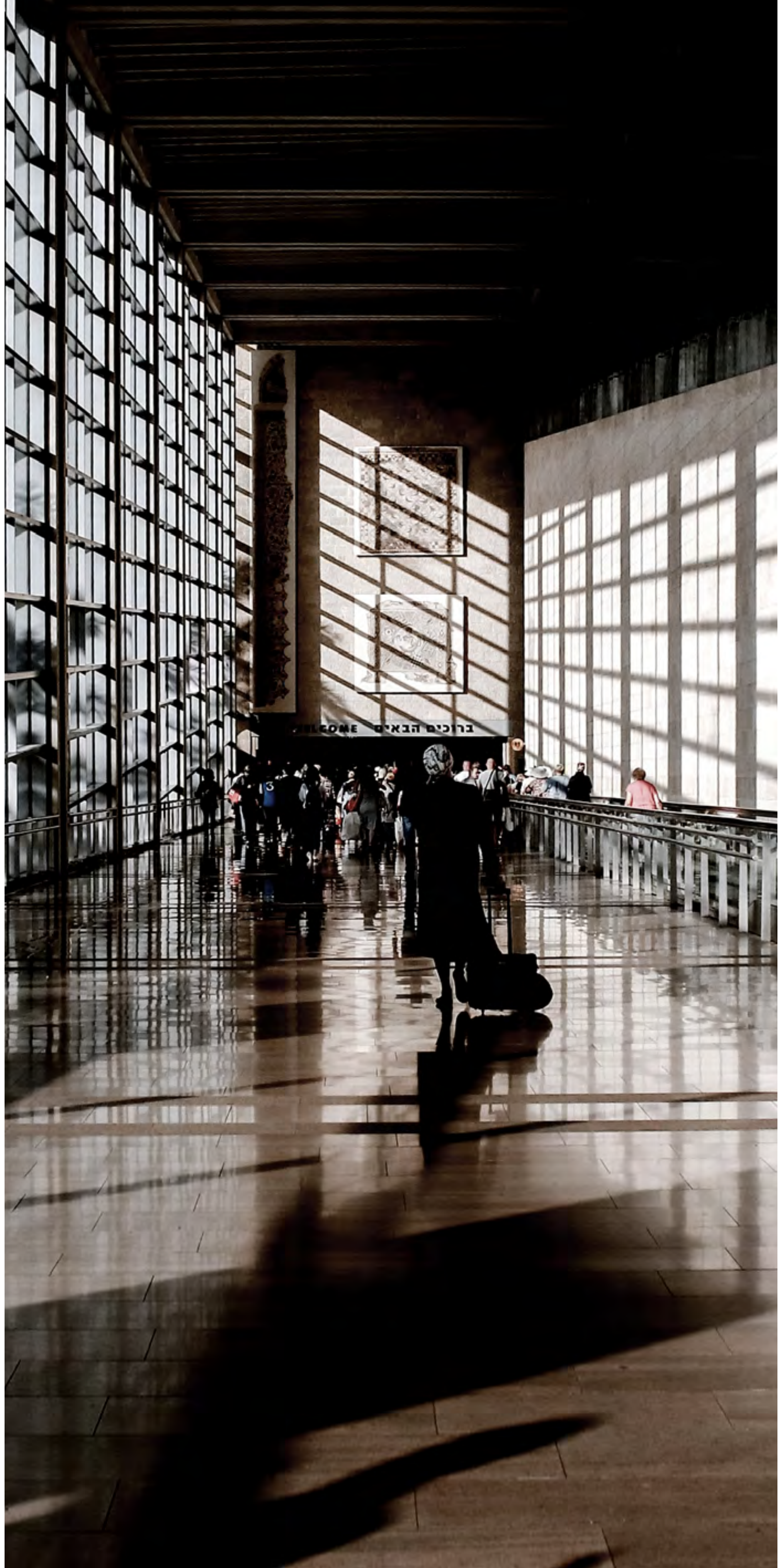
The basics

Spot Trade

The Forex spot rate is the current exchange rate at which a currency pair can be bought or sold. It is the prevailing quote for any given currency pair from a forex broker.

Forward Contract

Unlike a spot trade, a forward contract allows you to fix an exchange rate for a period of up to two years. This allows the buyer to protect themselves against the ups and downs in the market. The contract may require the buyer to pay a deposit. The buyer may decide to make partial drawdowns from a forward contract, reducing the balance as and when they need the funds. There are no penalties for early settlement.



Other terms

Limit Order

Limit orders are used as a tool to buy currency at a better rate than the current market rate. They are typically used in an appreciating market, where the buyer believes the appreciating trend will continue. Once the desired rate has been selected, the currency desk will execute the order, automatically buying the currency when the rate is available.

Stop Loss

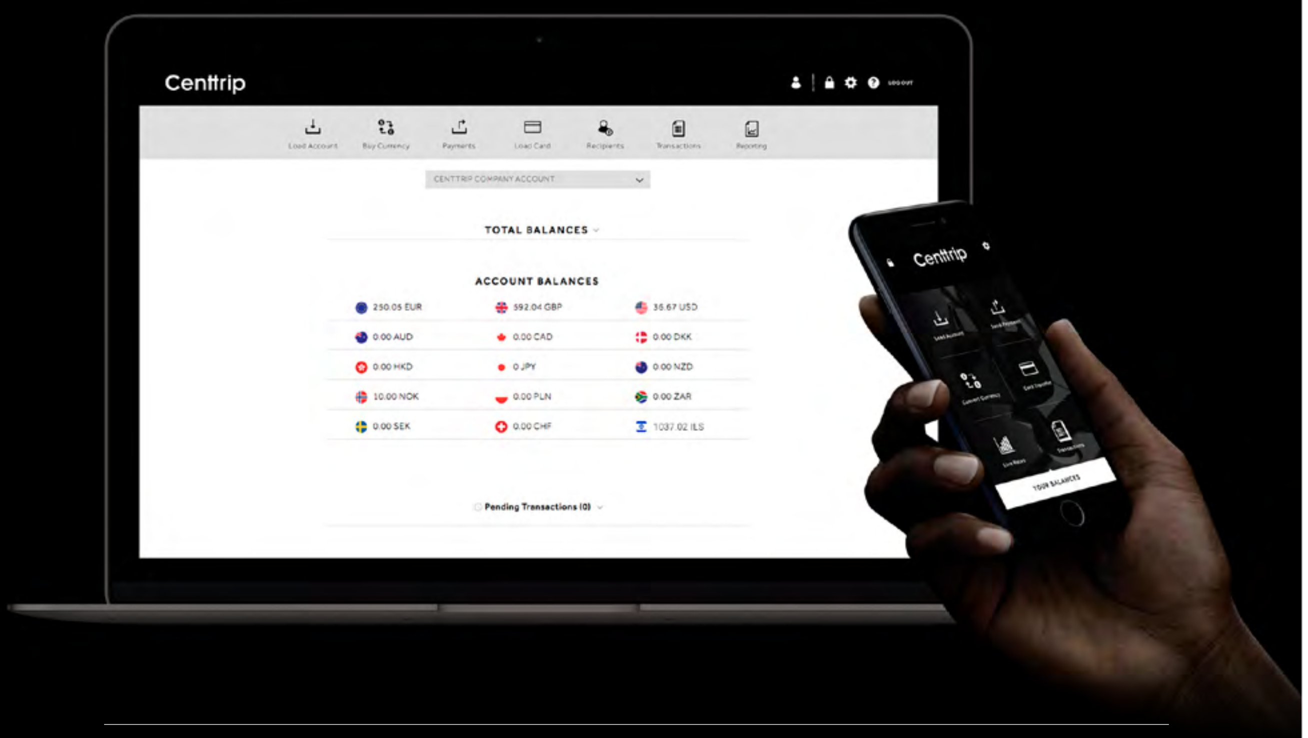
A stop loss order is the opposite of a limit order and can be used, as the name implies, to stop further loss when an appreciating market starts to reverse. These are typically used to protect the buyer from buying currency at a poorer rate than expected or required.

OCO

This stands for One Cancels Other and is a combination of both a limit order and a stop loss. If the market appreciates and the limit is triggered, the stop loss will automatically be cancelled. Conversely, if the stop loss is triggered the limit order will automatically be cancelled. These are best used where a buyer wishes to take advantage of a positive market move, whilst protecting a key level.

About Centtrip's Dealing Desk

Founded by foreign exchange entrepreneurs, Centtrip has a deep understanding of foreign currency markets.



We work with clients in all sectors including music, marine, private aviation, film & TV production and the arts, meeting their foreign exchange requirements and providing insight on currency markets to help them make informed decisions.

Centtrip is built on long-term, trusted relationships. Taking the time to understand a client's business and helping them find the best solution for their unique situation is part of our service – not a time-based, additional charge.

It means, we're better placed to recommend the solution that's right for the situation, whether that's reducing currency risk in future cashflows, or helping manage international, multi-currency payments.

Meet the team

Julian Justice

Head of Dealing

Julian heads up the FX desk at Centtrip and is responsible for managing some of Centtrip's most valued relationships. A graduate of Business and Economics from Leeds University, Julian's career in FX has spanned over 10 years, seeing him work at some of the biggest firms in the City. A highly experienced dealer, Julian has worked with businesses in many different industries to help them get the best out of the market, whilst mitigating risk. Outside of work, Julian enjoys spending time with his family and is a keen amateur cook.

Ben Blacker

Senior Dealer

A graduate in Economics from Southampton University, Ben has forged a career in the foreign exchange market spanning the last eight years. Working across sales and dealing desks, he has worked with FTSE 250 companies, helping them build hedging strategies that mitigate risk. Outside of work, Ben will be often found on the golf course, or playing for his local hockey team.

Max Heale

Associate Dealer

Max started his career as a junior at one of the largest and most respected brokers in the City, before being promoted to their sales desk. From this point, Max has worked with clients from a range of industries to maximise their FX requirements and implement effective hedging strategies. Outside of work, Max's passions are football and fitness.

"The whole Centtrip team is very knowledgeable and very, very pleasant. They can't do enough for you and they won't let you off the phone until you're happy."

Graham Watson, Head of Financial Accounts, Royal Opera House

The Centtrip platform

Centtrip's award-winning solution gives you real-time, anytime visibility and control over multi-currency deposits, international payments, foreign exchange and multi-currency cards. We help you streamline payments, reduce currency and cash-carrying risk, and optimise international income flows.

With Centtrip, you can deposit and manage 15 different currencies, in unlimited value, in a single account. You can manage foreign exchange in 140 currencies at live-market rates and you can make international payments across the banking network using SWIFT, SEPA, Faster Payments and other local networks. Centtrip customers can also make instant, fee-free, transfers and payments across the Centtrip network.

The Centtrip multi-currency, prepaid Mastercard is one of the most flexible cards on the market. Designed specifically for the needs of highly mobile organisations, the card offers the highest balance and transaction limits in the industry allowing you to hold up to £350,000 in 15 different currencies on a single card, spend up to £150,000 in a single transaction and withdraw up to £4,000 from ATMs. And, you can have as many cards as your project requires. It's not unusual for us to issue several hundred cards for a single, relatively short-term project.

Because we're designed for the needs of internationally-mobile business, you can control multiple, separate cost centres from a single, multi-platform interface – desktop or mobile – wherever you are.

We give you real-time reporting, reconciliation, insight and analytics, along with responsive, 24/7 support from experts who understand your world.

Recently ranked in the Sunday Times Sage Tech Track 100 list of Britain's fastest growing technology companies, Centtrip is trusted by demanding clients around the globe. These include film and TV production houses, music's biggest, global touring acts, the world's largest superyachts, private aviation fleets and more.

With Centtrip, you're always on the money.

"Centtrip helps us make tangible financial savings and maximise each foreign-currency transaction by providing expert market insight. It's a game changer."

Bill Curbishley, Trinifold Management (The Who)

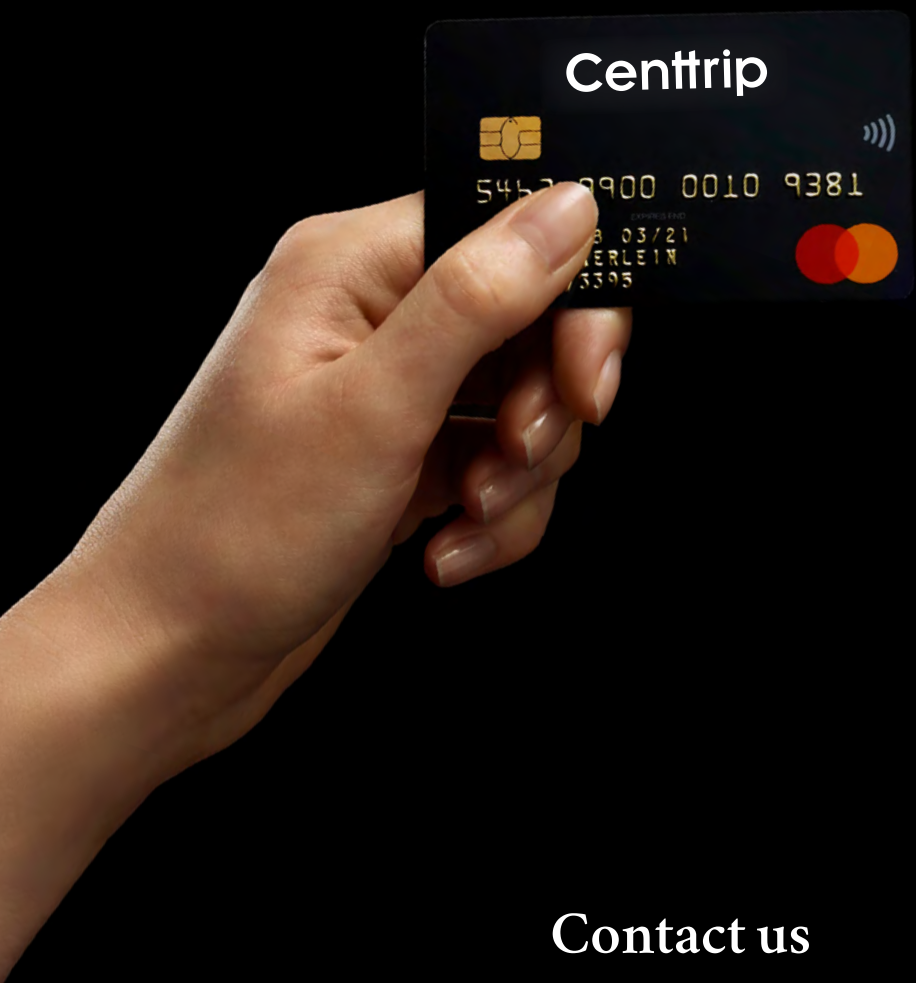
Managing currency risk

In an increasingly globalised world, we are ever more exposed to the risk of foreign exchange rate movements.

It's a more volatile world too, these days. Stakeholders are looking to mitigate and minimise risks where they can, seeking certainty wherever it can be found. In such a climate, not having a currency strategy can be a big gamble.

In this guide, we've explored the basics of creating a currency strategy to understand and manage your business's exposure to currency risk.

If you'd like to know more about how Centtrip can support your international business, contact us today.



Contact us

Get in touch today to find out how Centtrip can help you develop your currency strategy.

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