Managing Uncertainty

Lessons of the Recent Currency Market Moves

Uncertain Future

We live in a world where the pace of change has relentlessly increased, and it is not going to get any better.

Technology progress of a magnitude that would have taken decades only fifty years ago now takes place in a few months.

Rapid change is not just the realm of technology, but also happens in politics (the rise of Narendra Modi), economics (the Eurozone crisis), international conflicts (Ukraine, Syria, Yemen...), markets (oil & gas, interest rates), and in many other fields.

Should we be surprised by the collapse of world oil prices that were supposed to stay above $100 per barrel for the foreseeable future based on shrinking reserves and China-led consumption growth?

Over the same short period of 5-6 years, the United States, known the world over as "gas guzzler in chief", has become the world's largest oil producer, surpassing Saudi Arabia and Russia. Did anyone pay attention?

Will Greece, the cradle of Europe, end up being its grave? Is Putin bringing the cold war back?

Uncertainty is everywhere, and we'd better adjust to it. Greece, shale oil, Vladimir Putin... black swans are everywhere.

Black Swans

In his best-selling book "The Black Swan: the impact of the highly improbable", Nassim Nicholas Taleb explains *"A black swan is a highly improbable event with three principal characteristics: It is unpredictable; it carries a massive impact; and, after the fact, we concoct an explanation that makes it appear less random, and more predictable, than it was."*

The reason for quoting N.N. Taleb is to draw the attention of business managers on the crucial importance of managing uncertainty.

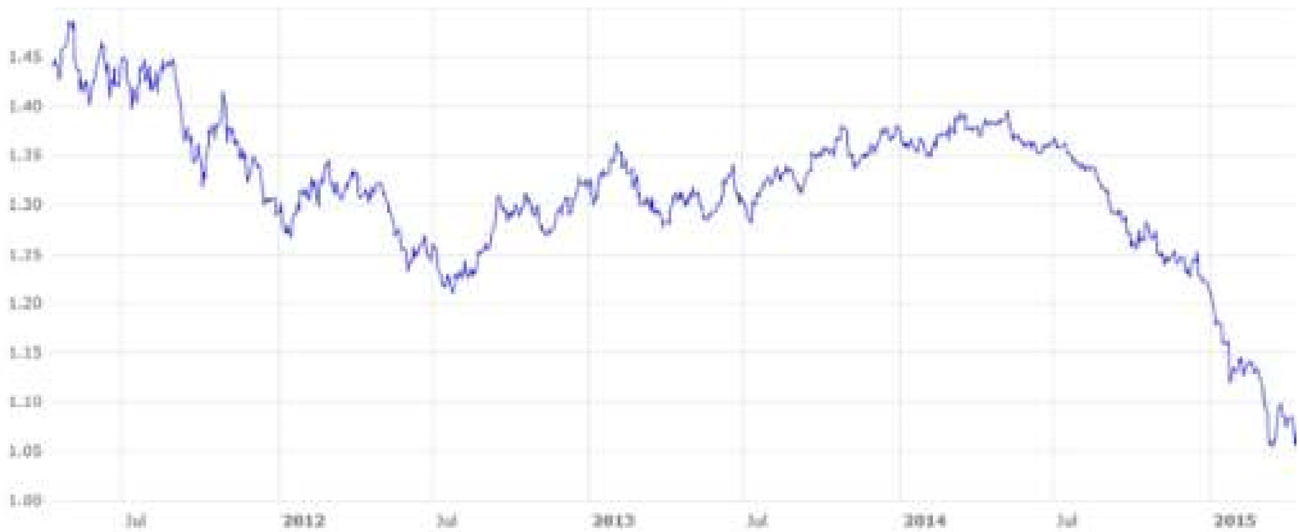
It can be summarized as an incentive to **measure and spread your risks** and to **maximize your capacity to change course rapidly** in case of unforeseen and upsetting events.

This is best illustrated by the example of the drop in the Euro value, $/€ 1.06 at the time of this writing.

How do companies look at the present $/€ exchange rate?

The CFO of a large corporation has the means and tools to manage both the transaction risks (accounts payable and receivable) and the translation risks (assets and liabilities) associated with currency moves.

Medium-sized firms are initially more concerned with their economic impact: *What is the present value of future operating cash flows and how are they affected by currency changes?*



If, in 2011 or 2012 (exch. rate around 1.40), you were exporting European-made goods in US dollars with a 20% gross margin, the same volume sold today (exch. rate 1.10 or lower) at the same US$ prices would raise your gross margin by 136%. In other words, on yearly sales of $5 million, your gross margin would jump from €714,500 to €1,688,000.

Of course, attractive $-denominated markets mean increased competition from Europe, and this quickly puts pressure on prices. Still, there is enough room to keep all fast movers happy.

Is it too late to join the bandwagon? As Danish physicist Niels Bohr famously said, predictions are hard to make, especially about the future! It is however not too late to draw a few lessons from what happened to the Euro over the course of the last 12 months.

- **Now is still the time to sell.** The $/€ exchange rate will not go back overnight to 1.40. It may take many months, probably years during which US$-denominated markets continue yielding attractive margins. This may be time enough to explore the US marketplace, set up a market penetration strategy and start selling. The key factor to limit the market and exchange rate risks is to keep your investments and commitments (funding, leasing and hiring contracts...) to a minimum and to rely on specialized firms, short-notice contracts and carefully selected partners.

- **Learn now and invest later.** After a few years, your US market penetration may have generated enough cash flow to start thinking about investments, acquisitions or local production. Whether you want to buy a competitor, set up a joint venture with a local player or build a production unit, a successful investment will depend on how well you are prepared, how well you know the market and how well you choose the timing (see following point).

- **Become American.** Just like countless foreign residents in the USA end up applying for US citizenship to improve and facilitate their integration, your company may move part of its operation to the United States in order to reduce the exchange rate's impact, improve the supply chain and develop a "Made in USA" brand. This could be the aim of the investment moves described under the previous point. If by then the Euro value has moved back up, your US investments will be cheaper while US generated margins will be shielded from Euro rate variations. In your consolidated balance sheet, however, your US assets will have to be protected by the appropriate "translation risks" hedging strategy mentioned earlier.

Make currencies part of your business plan.

Can you break down your total revenue per major currency? How many countries do you sell to in US dollars or dollar-pegged currencies? What proportion of your inputs are sourced in dollars? How much does your competitive position depend on the exchange rate? How much does the exchange rate affect the value of your assets, of your company?

If, as we showed earlier, the currency rate can, somehow magically, raise your gross margin from €714,500 to €1,688,000 (with a few caveats) the point is that exchange rates may have a disproportionate impact on your company's results.

Keeping track, on a weekly or monthly basis, of the main currency values you are exposed to, and weighing the impact of their rate variations on your forecasted revenue and gross margin should be an essential component of the CEO's dashboard.
As soon as a trend is identified, and as soon as a red line is coming near, the CEO will be able to take the appropriate measures to either **go forward** or **retreat** in the relevant markets, or to **adjust** its currency hedging strategy.

You only know for certain what you can measure. And you can only adjust to unforeseen events by staying nimble.

Our advice to conclude the subject is to rely on local partners to support your initial market penetration and to limit your initial investments, while committing more sizeable funds to this market only when you can shield the invested capital from currency moves and market uncertainties.

With best personal regards,

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