

Risk shift

As the Australian dollar and commodity prices rise, treasurers are refocusing hedging strategies with an emphasis on shorter term hedging and flexible pricing structures, Shaun Drummond writes.

After many years of relying on long-term cyclical correlations between the Australian dollar and the oil price, Caltex last year was forced to start paying for forward exchange contracts to protect earnings. Volatility and the inexorable shift back to high prices for oil after the global financial crisis were the catalyst for change as their high levels increased the impact of movements in their value.

"Significant exchange rate volatility has had a material impact on Caltex's profitability over the past few years," its treasurer David Davies says. "This was highlighted in 2008 when the value of the Australian dollar fell significantly against the US dollar in the second half of the year, causing a material negative impact on our earnings. During 2009, the Australian dollar

rebounded to partially recover some of these losses."

The Caltex board decided that it would introduce a policy of hedging 50 per cent of its US dollar crude and product payables exposure after applying natural hedges. "This program will dampen the potential impact of exchange rate volatility," Davies says.

The natural hedges Caltex uses include embedding \$US exposure within its refiner margin. The refiner margin is the difference between the cost of importing a standard basket of Caltex products to eastern Australia and the cost of importing the crude oil needed to make that basket of products.

Davies says Caltex didn't use hedging previously as the oil price before 2008 was much lower and so the impact of exchange rate volatility on what it paid for crude oil was less significant.

He says Caltex didn't so much rely on correlations per se as the "cyclicity of commodity and currency prices over time." But he says understanding the relationship between individual commodity price movements and their impact on the business is critical when modelling and developing an appropriate risk management strategy. "Correlations do play an important role in this analysis," he says. "But more critical to this is the understanding of the impact of movements in these correlations through time."

Correlations strengthen and weaken over time, and may or may not be present when needed. "But a breakdown in correlations at a crude price of \$US150 [a barrel] will have a much larger impact on the business than at \$US40 due to the quantum of numbers involved."

Paul Travers, executive director of risk management adviser Oakvale Capital, says many treasurers in exporting companies are finding it hard to accept that the parity of the Australian dollar with the US dollar will last and this is reducing the amount and duration of hedging. "We've found the exporters to be more and more reluctant to hedge," he says. "An expression that a couple of them have been using is that they're 'struggling to accept parity'. This is partly because parity is a psychological barrier, and so it is viewed as 'parity' rather than just a number going from 99¢ to the dollar to one to one, and above. Their hedging reflects a view that this is an exceptional situation."

The experience of the GFC is feeding into the caution because they know the Australian dollar is volatile and is likely to plummet if the world economy sours again, or if something dampens demand for our commodities. "So we've seen a trend for exporters only to hedge to their minimum levels," Travers says. Exporters will typically have a minimum amount of hedging of the currency, among other factors, over

ROB HOMER

a set period and they are sticking to that minimum.

The question everyone is grappling with, however, is whether this is the new normal and, although shocks may push it down again, whether the present level may be what the Australian dollar will return to for the foreseeable future. Travers for one thinks there's a strong case for that.

"Exporters need to be sitting down and thinking about their business mix," Travers says.

"I have a view that a new band is being set for the Aussie. It's drifted up in value on average, and you get corrections as you go along. It's gone back down to the US80¢ to the Australian dollar in the past, and now that will be considered the lower level."

Reader ROI

- ☒ **High commodity prices and volatility are forcing some companies to hedge where they haven't before.**
- ☒ **Treasurers are struggling to believe parity with the US dollar will last.**
- ☒ **Miners hedge costs rather than revenue, to pass on full commodity price rises.**



David Davies,
Caltex: Before
2008, the oil price
was lower and the
dollar less volatile,
so Caltex didn't
need to hedge.

In his view, three factors are behind the new higher band: high Australian interest rates relative to other developed economies, the strength of the commodity sector and the stability of our markets.

"Those three things make the Australian dollar an attractive investment," he says. "Will the Aussie get back down to the 50¢ level? I struggle to see that."

Price control

For importers the story should be all good at the moment. It is certainly better than it was in the depths of



▶ **ROI**
 Relationships Of Integrity

(L-R) GEOFF RODGERS – CHAIRMAN, ROWLAND & DAMIAN WRIGHT – PARTNER, BDO.

ROWLAND & BDO

"BDO has been our closest business adviser for 15 years. Their contribution to, and focus on, Rowland has significantly helped our growth as one of Australia's largest corporate communication consultancies, specialising in corporate affairs, stakeholder and employee engagement, government relations, creative, and crisis management."

GEOFF RODGERS – CHAIRMAN, ROWLAND

Using a hands-on approach, BDO has provided business and finance advice that Rowland trusts, including access to a range of value-adding services.

At BDO, we appreciate that each client is different, your distinctively different needs drive our approach.

Distinctively different – it's how we see you

1300 138 991
www.bdo.com.au



the GFC for listed wholesaler HGL. But the company's chief financial officer, Andrew Whittles, who says currency movements "are the air we breathe", points out that all their competitors get the same cost reduction advantage from a rise in the currency and equally they all suffer when the dollar falls.

"As the Aussie dollar rose up again to parity, all other things being equal our profitability would soar," he says. "It doesn't soar because it gets competed away."

However, it depends on the speed and the amount of the change, of course, as well as the timing. When the dollar dropped from US95¢ to US60¢ in a few weeks during the financial crisis, and then demand fell as well, the company did struggle as it was outside hedging ranges and it takes time to negotiate with suppliers and customers. They did what they could to keep people, but ended up having to shed 10 per cent of staff.

Now, Whittles says, the Australian dollar may scale even greater heights, but the feeling is it won't stay there for long.

He hedges about 50 per cent of HGL's foreign currency requirements about three to four months ahead using a combination of \$US accounts and forward exchange contracts. If there are sudden large movements upwards in the exchange rate, those competitors that haven't hedged will get an advantage. But that insurance gives HGL time to reset its prices with suppliers and customers.

One of the main reasons it survived the huge falls in the dollar during the GFC is that it didn't have long-term supply contracts with large retailers. It ensures it has price flexibility.

"If your product cost goes up by \$30 on a product (due to currency movements) on which you're only making a \$25 gross margin and you can't put your prices up, then you're in trouble," Whittles says.

"We're not selling to a Coles or Woolworths on a 12-month fixed

Paul Travers, Oakvale Capital:
A new higher band is being set for the value of the Australian dollar, but exporters expect the dollar's value to fall again soon.

supply contract. If we were, then we'd be taking out 12-month hedging agreements. But even at the end of the contract period the large retailer might say, 'sorry, I'm not prepared to up your price because in the meantime I've found a cheaper product, no brand, which I'm going to apply.'

Miners focus on costs

Resource companies are exporters that don't have to worry too much about the currency as high prices for their commodities are part of the reason for the high dollar. For many, that demand-driven rise in the prices they can get for what they sell cancels out the high dollar.

But their investors want exposure to the high and rising price. Oakvale Capital's Travers says for that reason resource companies have been shifting their hedging away from revenue to costs to make sure their shareholders don't lose that benefit.

"They want to try to pass the benefit of any underlying strength in their commodity price to their stakeholders," he says.

However, he says, the companies also recognise that they should still cover their risks. So the focus of hedging has been shifting to discussions on hedging costs, rather than hedging revenue.

"Where you're really at risk is in the Australian dollar costs that you have," he says. "So there's a far greater focus on ensuring that you're hedging the revenue that you need to cover your operating costs. Rather than saying my revenue is 100 and I am going to hedge say 50 per cent of it, it's more like saying, well, if my revenue is 100 and my operating costs are 60, I might hedge 80 per cent of my 60." ☒



Interest rate hedging shorter

While the cash rate has been steadily rising in Australia, Paul Travers of Oakvale Capital says the long-term interest rates, which include the three-year and five-year swap rates over the BBSW that corporations base their hedging on, have moved within a range and have been lower for shorter term rates.

He says there are three reasons a company will hedge the interest rate: their bank tells them they need to, they have a policy that mandates they do and because it is a good time to

hedge. Short-term rates have been low and long-term rates high, so he says any recent hedging has been done for the first two reasons.

"You don't find a lot of corporates hedging beyond five years," he says. "It's more on an exceptional basis."

"The three- and five-year rates have been quite a bit higher than where the short-term rates are, so people have wanted to keep it as low as possible so they're not paying too much for their hedging."