Surviving a currency crisis

As a devalued ringgit continues to struggle, Malaysia's SMEs are discovering that foreign exchange rates are having major implications – even if they do not trade abroad

For many businesses, 2015 was a chastening one as they had to grapple with not only a slowing economy but also currency volatility on a scale not seen since the 1997-98 Asian financial crisis.

Along with other regional currencies, the ringgit has been battered and bruised. It capped its biggest annual decline since 1997, slumping 19% to the US dollar in 2015, making it Asia's worst-performing currency.

The ramifications of the ringgit's fall have been felt across the board, from the big corporations to small and medium-sized enterprises (SMEs). The impact is not only on the business community; the man-in-the-street has also been hit with higher prices of imported goods. Meanwhile, many parents with children studying overseas have borne the brunt of the ringgit's devaluation against major currencies including the greenback, the pound sterling, the euro, the yuan, the Australian dollar and the Singapore dollar.

On the surface, it would appear companies distributing and retailing imported goods as well as using imported materials would be hardest hit by the currency fluctuations. Companies with international operations that have earnings in devalued currencies are also affected when their subsidiaries report their financials in stronger currencies such as the US dollar or euro.

However, the risks facing businesses in times of currency volatility extend beyond these aspects, often into areas that are not immediately obvious. Businesses could be affected even if they don't trade overseas. They need to be aware that foreign exchange (forex) rates can have an effect on their competitiveness even if they are not involved in trading overseas.

According to William Mah, a partner in PwC Malaysia's risk assurance services practice, the impact to each business is different depending on the level of exposure to a particular currency. The risks, he says, include a drop in business volume, reduction in profits, ratings downgrade, financial losses, lack of working capital, inability to secure funding, inability to pay suppliers and borrowings. And, in the worst-case scenario, the business may become bankrupt.

Mah also notes that there are many different sources of foreign currency risks. 'Some risks are direct and immediate, while others are mere "paper" losses,' he says.

'For example, if the company has a major payment due to supplier or foreign currency debt repayment due in the next few weeks or months, and the currency is not favourable, the risks may be realised.'

On the other hand, Mah says, a loss from translation of results of foreign operations is an unrealised loss that only affects the group balance sheet. 'This statement may sound surprising but many companies don't have a good understanding of the sources and extent of their foreign exchange risks. 'Many companies seem to manage only the most visible risks but they often face greater exposure from less direct risks that are much more difficult to manage,' he says.

> 'Many companies don't have a good understanding of the sources and extent of their foreign exchange risks'

Mah adds that finance can provide an analysis of the source of the foreign currency risks within the company. 'Working with the other teams, finance can assist them in understanding the financial implications of different actions or strategies to manage the risks,' he says. 'For instance, what is the financial impact of hedging with forward contracts or refinancing foreign currency borrowings to the company's cashflows, profits or debt covenants?'

CS Goh, CFO of Karex, the world's largest condom maker, concurs that the finance department plays a crucial role in helping companies mitigate foreign currency risk. He says that, in times of currency volatility, it is difficult for companies to forecast and determine costing for quotations to customers. 'The finance team helps the company manage such risks by monitoring currency rate movement and recommending a hedging policy for the group,' he says.

'Many of my bankers came to explain to me various hedging products that can help to mitigate foreign currency risk,' he continues, adding that the company hedges 60%-70% of its net exposure – that is, net of receivables and payables. He explains that 90% of Karex's revenue is denominated in the US dollar, as is 30% of its cost. 'It's a natural hedge,' he says, pointing out that hedging won't cost the company more but it does need to have facilities with the bank for this purpose.

Small businesses at a disadvantage

Given their size and financial resources, large corporations would appear to be more prepared to manage forex risks compared to SMEs. A 2013 ACCA-Kantox report, *Hedging FX risk – taking stock of the challenge for mid-caps and SMEs*, reveals that SMEs with international activities are significantly exposed to foreign exchange risk of which only a part is hedged and even less is managed in an active manner.

The report notes that, despite good intentions, SMEs and mid-caps do not actively manage forex risk. Frustrated by complexity and cost, and with only limited resources and access to relevant skills, some may resort to overly expensive hedging methods or taking their chances without hedging. Respondents who chose not to hedge FX risk usually cited high costs, complexity of developing a successful hedging strategy or collateral requirements as the main reasons.

Mah notes that the larger companies usually have established foreign currency risk management policies and good information systems which provide the information required to manage the risk. They have also »

Taking stock of currency fluctuations

The ringgit has been on a wild ride for much of 2015. It has weakened against most major currencies to the extent it has become a serious worry for government policymakers, businesspeople and the public.

The anaemic ringgit has been pummelled by a perfect storm of plunging crude oil prices, accelerated capital outflows, falling foreign exchange reserves, slowing economy and political uncertainty, and has plumbed the depths last seen during the Asian financial crisis of 1997-98.

So what strategies should businesses adopt to tackle the impact of forex fluctuations?

According to William Mah, a partner in PwC Malaysia's risk assurance services practice, companies should do a quick stock take of their situation. The immediate concern, he says, should be their survival through the current crisis. Some of the questions they should ask include:

* What is our 'real' exposure to foreign currency? What does a 10% depreciation in the ringgit mean to our bottom line?
* Do we have major committed expenditure or loan repayments due in the near future?
* How much headroom in our key financial ratios do we have before breaching loan covenants?
* What is the impact of foreign currency on our working capital? Do we need more funding?

Once they've weathered the crisis, companies must consider the impact of a weakened ringgit on their business strategies, Mah adds. These issues will then need to be addressed:

* Can they pass on the higher costs to customers?
* Do they need to switch suppliers or refocus on different markets?

hedged their foreign currency risks in accordance with their risk appetite.

'Smaller companies, however, typically would not have the resources and have therefore not paid much attention to foreign currency risks as the ringgit exchange rates have only moved within a relatively small band in the preceding few years against major currencies such as the US dollar,' he says, noting that PwC has been assisting companies in understanding the sources of forex and their implications on their profits, including scenario analysis and hedging strategies.

> Some SMEs may be resorting to overly expensive hedging methods or taking their chances without hedging

Lower purchasing power

The common perception is that as the ringgit devalues and materials costs rise, the natural thing for manufacturers is to pass on the increase to customers and consumers. However, that may not necessary be the most prudent thing to do, according to the CFO of a US multinational with operations in Malaysia and the region.

'The weakening consumer sentiment in Malaysia and across South-East Asia markets as a result of the lower purchasing power will affect our market share if we react with a blind price increase,' he says. He adds that his company consciously holds prices for entry-level products, especially in its main regional markets of Malaysia and Indonesia, whose currencies incidentally are two of the worst hit in Asia Pacific. 'We selectively increase prices only for the price inelastic items in our range of products,' he says.

At the same time, the group is exploring ways to make its products more cost-effective. 'We look at our cost and streamline it to make our cost structure more efficient. Having a price increase is our last option.'

On the flipside, there are many businesses that benefit from forex fluctuations, particularly companies that earn the bulk of their revenue in the greenback, euro or pound sterling. Local examples are furniture and glove makers, which have seen their profits and their share prices rising as the US dollar soared against the ringgit.

However, the tide can just as easily turn against you. As exchange rates can go both up and down, it can be tempting to gamble that this will work out in your favour. This is risky for businesses and could land them with a significant financial loss. Mah says that businesses should generally not look to 'benefit' from forex fluctuations, unless they consciously take a position or 'bet' on this. 'One way to benefit from this is to lock-in the favourable exchange rates, by entering into forward forex contracts,' he says. 'This allows the company to continue to enjoy the favourable rates, even if the dollar depreciates in the future.' Nevertheless, he believes that any 'benefit' should be a result of the nature of their business, for example, an export business which earns in US dollars.

Goh agrees. 'Obviously the strengthening of the US dollar versus the ringgit will improve our bottom line but we have no intention to make profit in this area,' he says. ■

MK Lee, journalist

For more information:

Download *Hedging FX risk – taking stock of the challenge for mid-caps and SMEs*, at bit.ly/hedge-sme