Foreign Exchange Risk & Business Investment

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1) Generate Maximum Shareholder Value

2) Earn, at a minimum, the Opportunity Cost of Capital (a.k.a. the “hurdle rate” or “minimum rate of return”)

3) Ensure proper Governance & appropriate Incentives
Foreign Exchange Risk is a key element of business exposure that must be managed if a Firm is to achieve the Goals of Corporate Finance.

Let’s look at the three types of Foreign Exchange Risk.....
Three Types of Foreign Exchange Risk

Translation Exposure
Changes in reported owners’ equity in consolidated financial statements caused by a change in exchange rates

Operating Exposure
Change in expected future cash flows arising from an unexpected change in exchange rates

Transaction Exposure
Impact of settling outstanding obligations entered into before change in exchange rates but to be settled after change in exchange rates
Translation exposure, also called accounting exposure, is the potential for accounting-derived changes in owner’s equity to occur because of the need to “translate” foreign currency financial statements of foreign subsidiaries into a single reporting currency to prepare worldwide consolidated financial statements.

This, however, is not the only type of Foreign Exchange Risk, there are two others which are arguably more critical to a business, namely........
- **Transaction exposure** measures changes in the value of outstanding financial obligations incurred prior to a change in exchange rates but not due to be settled until after the exchange rates change. Thus, this type of exposure deals with changes in cash flows that result from existing contractual obligations.

- **Operating exposure**, also called *economic exposure*, *competitive exposure*, or *strategic exposure*, measures the change in the present value of the firm resulting from any change in future operating cash flows of the firm caused by an *unexpected* change in exchange rates.
Transaction vs. Operating Exposure

- Transaction exposure and operating exposure exist because of unexpected changes in future cash flows.

- The difference between the two is that transaction exposure is concerned with future cash flows already contracted for, while operating exposure focuses on expected (not yet contracted for) future cash flows that might change because a change in exchange rates has altered international competitiveness.
The tax consequence of foreign exchange exposure varies by country.

As a general rule, however, only *realized* foreign exchange losses are deductible for purposes of calculating income taxes.

Similarly, only *realized* gains create taxable income.

“Realized” means that the loss or gain involves cash flows.
Businesses possess a multitude of cash flows that are sensitive to changes in exchange rates, interest rates, and commodity prices.

These three financial price risks are the subject of the growing field of financial risk management.

Many firms attempt to manage their currency exposures through hedging.
The value of a firm, according to financial theory, is the **net present value of all expected future cash flows to be generated.**

The fact that these cash flows are **expected** emphasizes that nothing about the future is certain.

**Currency risk** is defined roughly as the variance in expected cash flows arising from unexpected exchange rate changes.

A firm that **hedges** these exposures reduces some of the variance in the value of its future expected cash flows.
Business Impacts – So, why Hedge?

Hedging reduces the variability of expected cash flows about the mean of the distribution. This reduction of distribution variance is a reduction of risk.
Questions & Answers

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