

Currencies – Up and down and roundabout

We look at what impact currency movements can have on companies.



With the current market turmoil you could easily have missed that over the summer period the 5 year run of unrelenting weakness in the \$ showed signs of coming to an end.

For a decade between 1992 and 2002 the £ traded between \$1.40 and \$1.60 before reaching a \$2 conversion rate that sent many of us to the Disneyland queues. However, earlier this year sterling fell to its lowest level since October 1996 as measured against a basket of currencies

with the \$/£ exchange rate falling to \$1.75 in early September. Obviously our holiday finance is affected by these ups and downs but companies feel these rate movements even more keenly.

These exchange rate movements occur for a multitude of reasons. For example, recent comments from the Chancellor of the Exchequer and the Bank of England on the economy and job losses have pushed the £ lower; conversely the fall in Russian markets, which forced the

closure of long rouble positions has boosted the \$.

The level of the £ is important because it determines the sterling value of profits earned in other currencies by a UK company's overseas subsidiaries. It also influences, over a period of time, the competitiveness of British exports in other markets and of imports into this country, including imported raw materials. Here, we look at both these impacts.

Profit Impact

UK Company XYZ has an American subsidiary which earns \$50 million. Let's look at 4 rates taken from over the last 25 years and compare the impact on profits.

Rate	Sterling equivalent
\$1.05/£1 (1985 rate)	£47.6 million
\$1.50/£1	£33.3 million
\$2.00/£1	£25 million
\$1.75/£1 (recent rate)	£28.57 million

The table demonstrates how the sterling value of these profits changes with currency movements.

One sector hit by sterling's fall is leisure and travel. This summer's holiday-makers don't need reminding about the strength of the euro; destinations that were once regarded as cheap in spending terms, now feel on par with being at home, but with the sun shining. The high profile collapse of XL highlights the difficulty for travel companies. Holidays are priced well in advance, but the supplier often gets paid at a later date. The decline in sterling against the euro has narrowed profit margins and in some cases profits have been completely wiped out.

Well-run companies are aware that they can be vulnerable to currency movements and the majority, as a result, will put in place forward transactions to reduce or

delay their impact. According to Moneycorp, the foreign exchange specialist, there has been a dramatic increase in recent hedging against the £. But if the rate change proves to be lasting then this action merely defers the profit setback. Another option where a company is an importer of dollar-denominated raw materials is to look for a source from a eurozone supplier.

Investors are advised to look at how a company's management is handling their foreign currency exposure. In the report and accounts this information can be found in the notes relating to profit and loss and the balance sheet; in the statement on recognised gains and losses.

Price impact

Currency movements also impact exporters. In this example, company ZYX exports a product costing £10 to America. Using the same rates as previously, let's see what the US price for the product would be.

Rate	\$ price of £10 product
\$1.05/£1	\$10.50
\$1.50/£1	\$15
\$ 2.00/£1	\$20.00
\$1.75/\$1	\$17.50

At a dollar price of \$10.50 or \$15, the product may be more attractive to consumers than a locally produced item. But with the recent rate of \$1.75/£1 the product price rises to \$17.50, potentially making the product uncompetitive when compared to either the local product or

other foreign competitors. The exporter may be forced to lower his price or accept reduced sales, in either case to the detriment of profits. At this rate the UK producer may benefit from a cost reduction on any imported raw materials used, but it is unlikely this will fully compensate for the price impact.

Of course for every loser there's a winner. As sterling falls, international property buyers stand to benefit, both from the exchange rate and from a discount on the asking price. Recently there has been a 20-30% gain from the fall in sterling, along with a decline in property prices. A buyer with dollars will now find a purchase in the UK around 23% cheaper than a year ago; one with Euros around 28% cheaper.

Investment options

So if you think sterling is likely to fall further in value, what are your options?

- 1 Consider changing to a foreign currency account. This is most suitable for cash rich investors or small businesses. You will need comparatively large sums and it is a risky play, as currencies are difficult to predict and at times highly volatile.
- 2 Look for companies that may profit from a weak £. Some of our largest companies generate a significant part of their earnings abroad: Diageo and Glaxo are two such companies; others include Experian, Yell, British Airways and Wolseley. Other companies, e.g. British Airways, may have a natural hedge to the £/\$ rate by receiving a proportion of their earnings in dollars.

At a glance

This year the dollar/sterling exchange rate hit \$2/£1 and later fell to its lowest level since October 1996.

Exchange rate movements occur for a multitude of reasons.

The level of the £ impacts both overseas profits and the competitiveness of British exports.

Investors should look at how a company's management are handling their foreign currency exposure.

There are various investment options should sterling fall further.

- 3 Gold has an inverse correlation to the \$, so if you think the dollar will rise in value — and many analysts in the long term do not — then consider moving out of any investments in gold, along with other commodities. Note one of the reasons for the recent fall in commodity stocks has been the rise in the \$, which has put pressure on commodity prices.

- 4 Consider buying foreign currency denominated bonds.

- 5 It is possible to spread bet currencies, however this is not something we would recommend for most investors.

Of course a company's fortunes are not solely dependent on changes in the exchange rate which can quickly move in either direction. Any investment decisions should therefore always consider the wider aspects of a company's financial strength, its future prospects and the prevailing economic conditions.

