Why Currency Headwinds Are Going To Define Earnings In 2016

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Summary

Companies seeking to optimize their profits with FX risk will seek to hedge.

Only about half of public companies currently hedge their FX risk.

Investors should consider FX for companies with significant international business.

Companies that do business outside of the USA have substantial forex exposure. This exposure can be an asset, if properly managed – but often it is a liability. Recently, the trend in corporate accounting has been to blame "currency headwinds" which can be a good excuse for up to $10 billion in losses. Did these executives ever hear about hedging?

Recently Toys R Us (TOY) said revenue "slipped" because of "currency headwinds":

> *Toys "R" Us Inc. said revenue slipped 2.6% in the latest quarter as the retailer faced currency headwinds over the holiday period. The foreign exchange volatility was partially offset by the rise of same store sales of 2.3% in the fourth quarter. Currency woes, however, had a negative $169 million*

> *impact. For the year, the toy store's same store sales increased a modest 0.9%.*

Let's examine how this $169 million loss could be a potential profit. Companies who do business overseas know roughly how much foreign currency they will have coming in. In the case of retail operations, such as Toys R Us or the best forex example McDonald's (NYSE:MCD), they know what their foreign sales are going to be, within a very small margin of error; retail stores operate in these thin margins of 2%, 5%, 8%, etc. Let's use the McDonald's example.

From RBTH (a Russian news source):

> *1. There are 517 McDonald's restaurants in Russia, 73 of which were opened in 2014. The company's total revenue for 2014 in Russia was 65.8 billion rubles ($930 million).*

McDonald's has 517 locations in Russia, which generate about $930 million USD in income. But when they receive this income, it's in rubles, mostly in cash (the Russian economy is not 'electronic' as most of western Europe is). Even if store sales slip, they know they should have at least about $900 million USD worth of rubles per year, or about $225 Million per quarter, to convert from rubles to USD. McDonald's is an American company, and the US dollar is its functional currency for accounting purposes. Knowing that they are naturally long RUB/USD for about $225 million per quarter, they can sell covered forex options or Forwards against this transaction. This would be pure profit for McDonald's because they already have the underlying waiting to be delivered. If delivery is not taken – even better. They get free money.

USD/RUB is quoted usually as USD/RUB, not RUB/USD. If you are long EUR/USD you are long the euro and short the USD. But for hedging purposes, forex pairs can be quoted in the inverse, especially in non USD jurisdictions where forex is active such as Japan, where it's common to see JPY/USD, JPY/EUR and so on.

Forex options are not so much different than options on stocks; they are just not so widely utilized. Options trading for stocks has become popular in recent years, and for good reason.

Some companies know this; in fact – some companies profit greatly from it. But according to insider research from CFO.com, only about half of public companies hedge:

> *Forty-eight percent of nonfinancial companies listed on U.S. stock exchanges remained exposed to volatility in foreign exchange rates, commodity prices and interest rates in 2012 because they did not hedge them, according to a new study by Chatham Financial.*
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> *The interest-rate and currency risk adviser studied a sample of 1,075 companies ranging from $500 million to $20 billion in revenue. The nearly half that did not use financial instruments to hedge their exposures demurred despite the threat the risks posed to both the balance sheets and reported earnings (see chart at bottom). "That was surprising, knowing the pressure senior management teams and treasury feel around identifying ways to reduce risk to factors within their control so business can focus on other areas," Amol Dhargalkar, managing director for corporate advisory at Chatham, says.*
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> *Fifty-two percent of firms with exposure to global currency fluctuations hedged FX risk, the firm found. Data released in September by the Bank for International Settlements showed a continuing decline in forex transactions for nonfinancial customers. Transaction dollar volume fell to $465 billion in 2013 from $532 billion in 2010.*

When times are tough, companies will pinch pennies, shed staff, and cut costs. But many public companies are already "mean and lean" – operating at near optimum capacity. But there's one obvious spot left to explore, to increase earnings – and that's forex hedging. Forex Hedging can provide protection from risks and even profit. Yes, it's a slippery slope of discussion – because we must always say that forex is risky and you will lose all your deposit, and it will cause poor health and ruin your business. But let's be practical; if a company is reporting a multi-million dollar loss because of "currency headwinds," it's already suffering these things without participating in forex. If regulators don't like such arguments, why don't they provide US companies with tools and methods to protect themselves from such headwinds.

So unless public companies quickly start learning and educating themselves about currency hedging, 2016 looks like a year of forex – a year defined by "currency headwinds" as far as earnings are concerned.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

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