

HEDGING FX RISK

Taking stock of the challenge for mid-caps and SMEs



Published in association with



A research report by



ABOUT KANTOX

Kantox is the alternative to traditional FX products and services offered by banks and brokers (spot, forwards, options, etc.). We have created a marketplace where companies can find counterparties to exchange foreign currencies spot and forward, without the intermediation of banks. Our client portfolio includes both SMEs and multinational companies.

Kantox is registered with the FSA (FRN 580343) for the provision of payment services, with HMRC for the provision of foreign exchange services and for anti money laundering purposes (Nr. 12641987) as well as under the UK Data Protection Act (Nr. PZ2909796).

ABOUT ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We support our 154,000 members and 432,000 students throughout their careers, providing services through a network of 83 offices and centres. Our reputation is grounded in over 100 years of providing world-class accounting and finance qualifications, and our long traditions are complemented by modern thinking, backed by a diverse, global membership. By promoting global standards and supporting our members wherever they work, we aim to meet the current and future needs of international business.



London, April 2013



« This paper reports on the findings of a survey of over 100 small and medium sized enterprises (SMEs) and mid-caps dealing in foreign currencies.



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About this study

The financial crisis that began in 2008 has completely changed the financial landscape. In this 'post-war' scenario, banks are being forced to deleverage, and companies are experiencing increased difficulties in getting access to credit and to financial derivatives with which to hedge risks. Small and medium-sized enterprises (SMEs) and mid-caps¹ are, as usual, much more affected than large corporates, but while several surveys have been published on the subject of FX hedging among large corporates, data on SMEs and mid-caps are much rarer and less complete.

The purpose of this survey was to take stock of the mounting challenges facing SMEs and mid-caps with an exposure to FX risk. The priority was to establish how such businesses assess the risk from FX rate fluctuations; how exposed they are to these; how they hedge against them; what they see as the main obstacles to hedging; and to what extent SMEs understand the costs involved.

¹ SMEs are defined by the European Commission as independent businesses with fewer than 250 employees, annual turnover of less than €50m and a balance sheet of less than €43m. 'Mid-caps' is a less well-defined term, originally used to refer to a particular segment of listed companies, but also increasingly used to refer to medium-sized-to-large businesses regardless of legal status, such as France's entreprises de taille intermédiaire (ETI) or Germany's Mittelstand. It is used here to refer to businesses above the SME threshold that still turnover less than \$1bn a year.

Kantox firmly believes that simple, transparent and low-fee solutions are the way forward for SMEs and mid-caps, and that derivatives – often prescribed as the most appropriate means of hedging FX risk – are unsuited to most businesses.

This study is based on a survey of 119 SMEs and mid-caps from more than 15 countries, carried out by Kantox FX in the second half of 2012. Most respondents were based in the US, France, Spain, the UK, Switzerland and Germany. The typical (median) respondent had revenues of just over \$200m and traded about 19% of revenue (just under \$40m) a year in foreign currencies, mainly USD, EUR, GBP, JPY, CHF, BRL and SEK.

FIGURE 1: BREAKDOWN OF RESPONDENTS BY COUNTRY OF ESTABLISHMENT

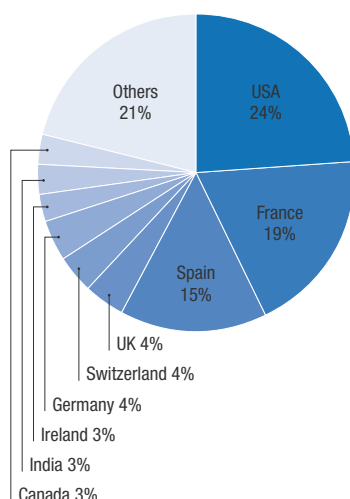


FIGURE 2: BREAKDOWN OF RESPONDENTS BY REVENUE

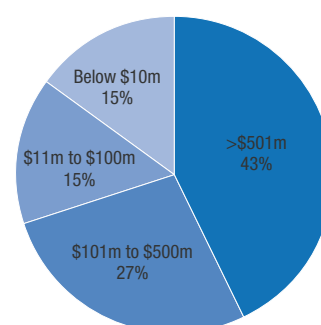


FIGURE 3: AMOUNTS TRADED IN FOREIGN CURRENCIES

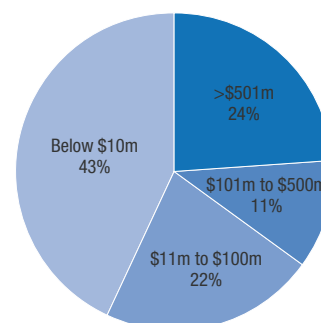
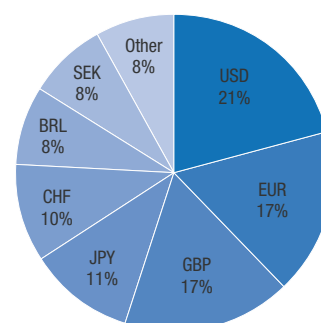


FIGURE 4: CURRENCIES TRADED



SMEs and mid-caps are significantly exposed, but insufficiently hedged

The majority (83%) of SMEs and mid-caps responding to the survey experienced FX losses or gains in 2012 due to exchange rate volatility. For one-third (33%) of respondents, the amount of FX loss or gain has exceeded \$1m, resulting in a direct impact on profit margins.

It is important to note that although many of these businesses will have seen FX gains this year, their exposure to FX risk means they could just as easily report losses in the future. Overall, small numbers of big winners and losers accounted for most of the gains and losses, although the typical respondent still gained/lost around one-third of a million dollars.

Despite these substantial exposures, 14% of the businesses in this sample still did not hedge FX risk. Those that did so usually preferred simple methods such as forward contracts and natural hedging (when possible), rather than more complex derivatives such as options or swaps.

Surprisingly, 13% could not say how much they hedged. Of those who did know, 39% hedged less than half of their exposure; the typical respondent hedged 59% of the firm's exposure.

FIGURE 5: AMOUNT OF FX GAIN OR LOSS IN 2012

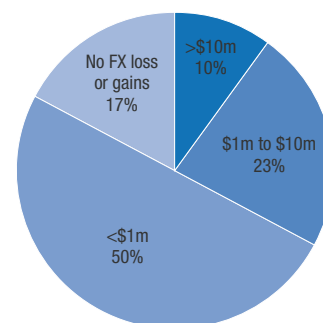


FIGURE 6: HEDGING METHODS EMPLOYED BY RESPONDENTS

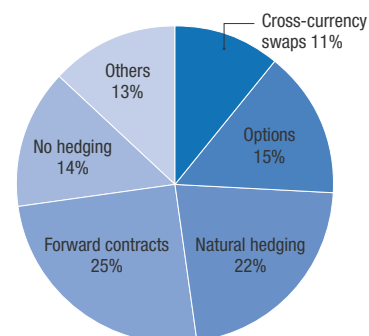
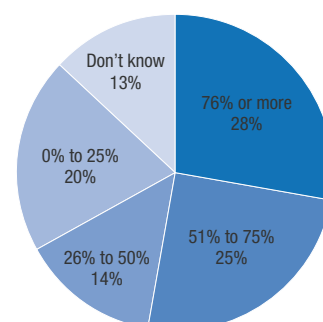


FIGURE 7: SHARE OF RESPONDENTS' FX EXPOSURE THAT IS HEDGED



Despite good intentions, SMEs and mid-caps do not actively manage FX risk

The majority (77%) of SMEs and mid-caps responding to the survey claimed to have a formal written FX risk-management policy. Only just over half (51%) of respondents monitored their FX exposure at least weekly; monthly monitoring, possibly aligned to the management reporting cycle, was a common alternative.

In times of high volatility, such as most of 2012, the 49% of respondents that were not monitoring their positions at least weekly were running a high risk of FX loss. Perhaps worse, 30% of respondents (including a minority of those with FX risk policies) did not analyse their exposure in order to understand their potential FX loss in the event of adverse market movements.

FIGURE 8: DO RESPONDENTS HAVE A FORMAL FX RISK-MANAGEMENT POLICY?

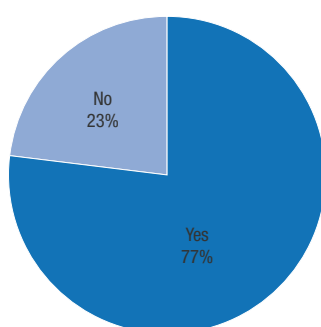


FIGURE 9: DO RESPONDENTS STRESS-TEST THEIR FX EXPOSURE?

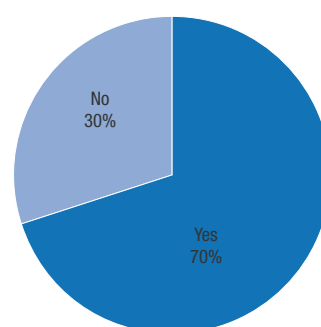
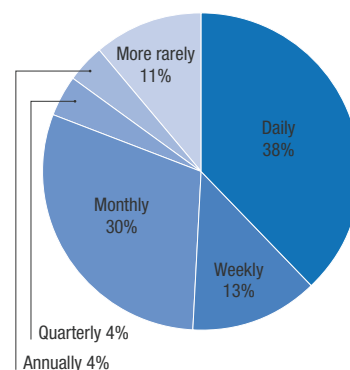


FIGURE 10: HOW REGULARLY DO RESPONDENTS MONITOR THEIR FX RISKS?



Business frustrated by the cost and complexity of hedging products

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. Such collateral is usually made up of credit lines (43%) or margin deposits and margin calls (27%). It is surprising to see that 28% of respondents claimed not to be posting collateral – but most are likely to have been using natural hedges of some type.

Discouraged SMEs and mid-caps may not be the only ones getting a poor deal: 35% of respondents did not know how much they were being charged by their bank to hedge FX risk. Kantox's experience suggests that even the remaining 64% were probably also being charged more than they realised or anticipated. Without access to live market rates and with no in-house FX expertise, SMEs and mid-caps can find it difficult or impossible to negotiate fair deals with their banks.

FIGURE 11: COLLATERAL REQUIRED FOR HEDGING

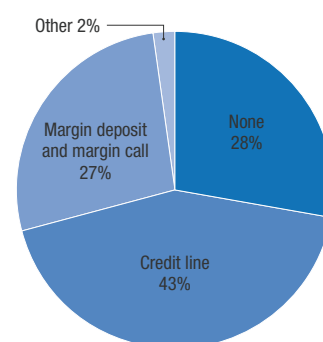
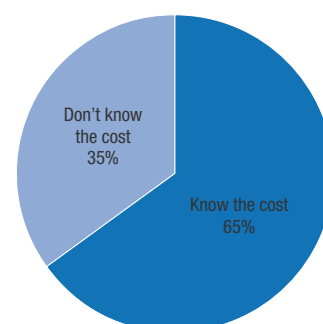


FIGURE 12: DO RESPONDENTS KNOW THE TRUE COST OF HEDGING THEIR EXPOSURES?





◀ The financial crisis and the new regulatory landscape are already affecting businesses' ability to hedge FX risk

A majority (60%) of respondents have experienced an increase in FX trading costs since the beginning of the financial crisis in 2008. Although this increase is still small in the vast majority of cases, the implementation of new regulations on bank capital requirements (Basel III) and over-the-counter (OTC) derivatives clearing is likely to worsen the situation in 2013.

Costs aside, since 2008 more than a third (35%) of SMEs and mid-caps have experienced increased difficulties when attempting to hedge FX risk with their banks: collateral requirements have increased, credit lines have lowered and getting quotes on some exotic currencies has become harder.

Finally, 70% of respondents were aware that under the new financial landscape, dealing with derivatives and FX hedging will become more expensive with their banks.

FIGURE 13: ARE RESPONDENTS FINDING IT MORE EXPENSIVE TO HEDGE FX EXPOSURES SINCE 2008?

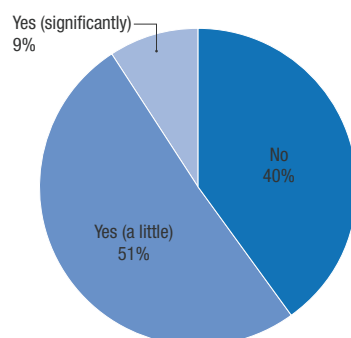


FIGURE 14: ARE RESPONDENTS FINDING IT HARDER TO HEDGE FX EXPOSURES SINCE 2008?

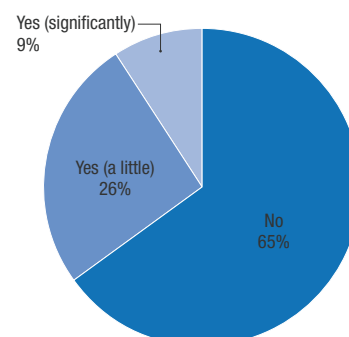
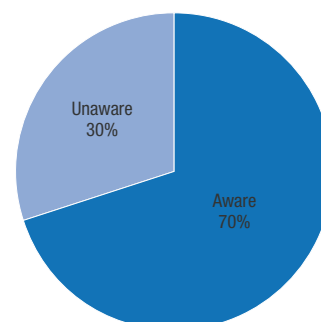


FIGURE 15: ARE RESPONDENTS AWARE OF THE EFFECT OF REGULATORY CHANGES ON THE COST OF FX HEDGING?



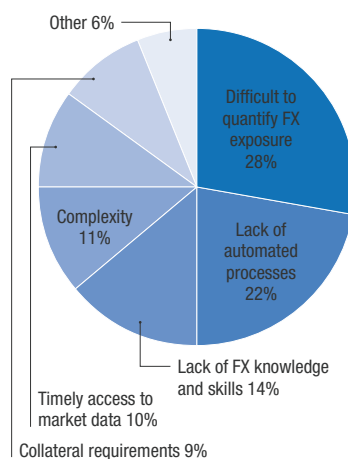
SMEs and mid-caps need simple, transparent and low-fee solutions

According to the survey findings, the biggest obstacle to FX risk management among SMEs and mid-caps is a lack of knowledge and in-house skills that would allow them to deal with the complexity of managing FX risk.

A practical constraint is the difficulty involved in quantifying FX exposure, especially for SMEs without state-of-the-art software and automated processes. Access to timely market data is not guaranteed among smaller businesses and can be expensive to arrange.

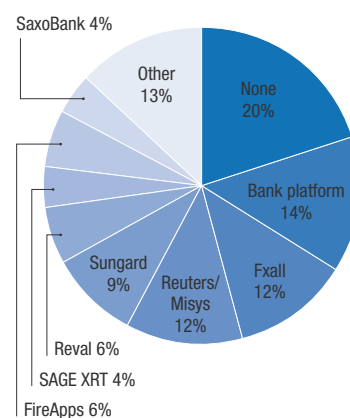
Finally, many cash-strapped SMEs may find it difficult to meet the collateral involved in hedging, as this tends to consume scarce working capital.

FIGURE 16: CHALLENGES ENCOUNTERED BY BUSINESSES SEEKING TO HEDGE FX RISK



Finally, it is worth noting that, despite acknowledging the complexity of managing FX risk, many SMEs and mid-caps (34%) still do not use any specific platform in order to do so, while some (14%) are forced to rely on their bank platform for this.

FIGURE 17: PLATFORMS USED BY RESPONDENTS TO MANAGE FX TRANSACTIONS



Kantox' vision

In Kantox, we truly believe that the financial industry needs a radical rethink. Transparent, innovative financial services offering fair prices and creating no systemic risk are more important than ever. Based on this vision, we developed Kantox, an alternative to traditional FX products and services offered by banks and brokers. We've created a marketplace where companies can exchange foreign currencies with others companies, spot and forward, without the intermediation of banks. Hence Kantox is able to offer a simple, transparent and fairly-priced FX solution.

Our investors include successful Web entrepreneurs and professionals coming from the financial industry with experience in companies like BNP, HSBC or Deloitte. Kantox was founded in London in June 2011 and is regulated both by the HMRC (MLR 12641987) and by the FSA under the PSR 2009 (reference 580343) for the provision of payment services.

ABOUT THE CEO

Philippe Gelis had 6 years' background in the consulting industry when he left Deloitte to create Kantox. His focus was on clients from the banking industry like Santander Group and clients from the Venture Capital industry such as PAI Partners or Palamon Capital partners. A French native, Philippe has an MBA from Toulouse Business School with a specialisation in Corporate Finance.



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