Protect against currency volatility

THINK TANK

***Enterprise* Rachel Bridge**

As managing director of fast-growing long-haul tour operator Tropical Sky, Mike Collins has a lot to think about.

One thing he does not have to worry about, though, is the effect of adverse exchange-rate movements on his profit margins. This is because he uses tools such as currency hedging to reduce his firm's exposure to volatility.

Collins, whose Sussex-based firm has a turnover of £35m, said: "For me it is not just a nice thing to do, it is absolutely essential.

"If the exchange rate suddenly moved sharply it could spell the difference between a profit-making sale and a loss-making sale. There are many ups and downs in business and a massive currency issue is one problem I wouldn't want to deal with."

Hedging has become something of a dirty word recently in the light of claims of interest-rate swaps mis-selling to small firms.

But the problems with interest-rate swaps should not overshadow the fact that currency hedging can be a great way for SMEs that trade overseas to protect themselves from the uncertainty of exchange-rate volatility.

Even a 10pc swing in the euro or dollar/sterling rate can be enough to wipe out the profit on a deal and a larger swing in the wrong direction could result in total financial ruin for an SME with no currency protection in place.

The good news is that while high street banks have traditionally aimed their services – and best rates – at large corporate clients, a number of independent foreign exchange firms have emerged to offer advanced currency services to SMEs, too.

Services typically range from forward contracts – where an SME can fix the rate at which it buy or sells currency on a future date, thereby locking in the profit it will make on a deal – to more complex structured hedging deals, in which a firm sets lower and upper limits at which it buys currency over a particular time period.

As increasing numbers of SMEs look to boost their exports to offset the poor UK trading climate, minimising the impact of currency risk has become ever more important. That's especially true because there can often be a long lag between agreeing a deal and settling the invoice.

Praveen Vijh, co-founder of health foods firm, Eat Natural, buys euros and dollars at a fixed price up to six months in advance to pay for imported raw ingredients. He says: "It means we have complete visibility on our forward planning so there are no surprises."

Such has been the popularity of hedging products, the British Chambers of Commerce last September started a currency hedging service of its own.

A study last year of 500 UK SMEs by American Express found that more than half did not protect themselves from currency risk when trading overseas, even though 36pc admitted currency fluctuations were their main concern.

Abhishek Sachdev, managing director of derivatives specialist Vedanta Hedging, said SMEs that do not manage their currency risk also put themselves at a competitive disadvantage.

He said: "If you and your competitors are all buying the same products from China or the Far East and selling them in Europe, the rate at which you buy your foreign currency becomes a key part of your profitability margin."

So how do you go about managing your currency risk? First, find a broker you trust. Then, start small, hedging 30pc to 50pc of your total currency exposure until you become familiar with how the process operates. Never be tempted to use currency hedging to speculate on foreign exchange markets – you have a business to run and your aim should simply be to protect your profits. Leave the gambling to the experts.

Rachel Bridge is an author, public speaker and journalist specialising in entrepreneurship and SMEs.