

## **Exchange and deliver: The benefits of effective currency strategy**

### **Introduction**

Fluctuating global exchange rates are one of the effects of the turbulent times in which we live. This means companies have a lot to gain by examining their currency strategies within a strategic sourcing context.

Most procurement leaders nowadays understand the potential benefits of buying from low-cost regions. But with the global economy becoming seemingly ever more unpredictable, it's no longer enough to know where you can buy goods and services at the best price. To achieve the most cost-effective deals procurement leaders must know about currency movements too.

Competence in this important area of business know-how can provide the confidence that your company is not only achieving a good price but also avoiding unnecessary risk. Yet fully thought-out currency strategies are surprisingly seldom considered among the sourcing levers available. Fortunately, however, there are a few simple techniques that can be quickly put into effect to achieve the best results for your organisation.

**Julian Catchick**  
**Principal**

### **Currency strategy and risk**

Procurement leaders are not expected to be experts in currency strategy but as with most other areas of business skill, they need to know who to turn to for advice. In this case, the company treasury will be the source of expert knowledge on international currency rates. In all matters of currency strategy the treasury - or equivalent depending on the company's structure - should be involved.

Broadly speaking there are two approaches to currency risk. A company can pay in its own domestic currency when locking in a deal for the life of a contract. This means, of course, that the risks of currency fluctuation are transferred to the supplier who will therefore undoubtedly build in a premium to account for this within its pricing. Alternatively, your company can pay in the supplier's local currency and take on the risk that the exchange rate can move up or down during the life of the contract.

### **Looking at the options**

Within these two approaches there are several options available. It may be possible for the buying company, paying in its own currency, to agree a fixed exchange rate over the duration of the contract, subject to regular review, whereby if it moves in either direction by more than a pre-agreed amount it will trigger an adjustment to the agreed rate which remains fixed until the next review.

Then there is the standard hedging strategy whereby the buying company buys in advance the amount of the supplier's currency needed to pay for the duration of the contract at an

appropriate time, possibly through an intermediary. Payments are then made in tranches either directly to the supplier or through the intermediary.

A further option is to agree a "collar" whereby the company buys a "call" option which gives the company the right to buy at a certain price if the commodity price rises above this threshold, and sells a "put" option which gives the supplier the right to sell if the commodity price drops below a certain threshold. It is likely you would need to set up the transaction through a financial intermediary. One major benefit of this approach is that it will be at a net cost of zero to the company: the idea is that premium received for the "put" option will cover the cost of the "call" option. The overall effect is to create a price collar, or range, within which the buying company can be sure it will purchase over the life of the contract. Hence the buyer takes greater control of the risk.

When sourcing the requirements you can ask suppliers to bid in their local currency and in the buying company's domestic currency. This way you can make a judgment about the amount of risk the supplier has factored into the exchange rate and compare it to the risk you are prepared to take by agreeing to pay in the supplier's currency. Either way, the question is how much risk is involved -- how much the two currencies may fluctuate against each other and in whose favour, who is prepared to take that risk on board and at what cost.

Finally you can conduct a "macro hedge" whereby you consolidate your foreign currency requirements across your various pipeline projects and then buy the currencies in bulk, securing better exchange rates, and then releasing the currencies as needed. This can be done by, for example, determining rates per item over a projected number of years from which an estimate is made as to what the exposure to foreign currencies may be as a percentage of the unit price. Alternatively, it can be done at a higher level whereby items are grouped into categories.

### **A two-way process**

It must be remembered, however, that whatever strategy is identified as being most effective, procurement is a two-way process and the supplier must be fully signed up to the deal. If not, the supplier is likely, quite understandably, to rebalance the relationship by introducing hidden costs or reducing quality or service levels.

Remember too that the supplier has almost certainly had experience of such strategies and may be able to discuss which will be mutually most effective in a given procurement operation. Then the risk is taken out of the equation and both sides can enjoy a classic win-win situation.