Infinity

Lending Certainty to SMEs in a Volatile World

Lender perspectives on effective foreign currency hedging strategies for SMEs

During the Summer of 2021, Infinity invited several leading independent lenders and advisers to participate in an important qualitative, interview-based study.

Its focus was to examine the key drivers and dynamics at play that are either accelerating or hindering the ability of UK SMEs to access expertise to mitigate their foreign currency risks.

The lender perspectives contained within this paper tell a story of a resilient SME segment facing unprecedented market volatility and uncertainty. The interviews explore the impact of Brexit and COVID-19 on business continuity and outline the transactional and economic risks facing UK businesses as they seek to navigate a new and increasingly complex world.

In the current volatile business environment, the desire to create greater certainty sits right at the forefront of every board agenda, every client relationship and every lender's mind.

Lenders have a pivotal and trusted role at the heart of the SME ecosystem. The funding support that lenders provide to the SME community is crucial to UK economic recovery, meeting the heightened demands on working capital as businesses emerge from the pandemic. However, Foreign Exchange (FX) and the mitigation of currency risk is still little understood by all but the most sophisticated mid-tier businesses with access to expertise and specialist support.

In this paper, senior lending professionals focus on FX in the context of the SME environment, demystifying the issues, without playing down the complexities and risks that volatility brings, and exploring some myths along the way.

The key findings are summarised under the following headings:

VOLATILITY – What is 'normal' anymore?

VOLUME – The myth that international business sales volume is the determining factor to hedging strategies for SMEs – and the overwhelming case for financial inclusion.

VORACITY – The appetite of UK SMEs to understand and embrace hedging strategies.

VIRUSES – The impact of catastrophic events, such as COVID-19, and the long-term changes requiring UK SMEs to look at their foreign currency risks.

VALUE – The opportunity for lenders to UK SMEs to assist their clients in exploring hedging strategies to mitigate foreign currency risk.

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- **Ian Duffy**, CEO and Founder, Accelerated Payments
- **Paul Marston**, CEO, The FSE Group
- **Steve Richardson**, Sales Director, Reparo Finance
- **Philip Squire**, Senior Underwriter, Arbuthnot Commercial Asset Based Lending
- **Lionel Taylor**, Managing Director, Trade Advisory Network
- **Robert Wakeford**, Managing Director – UK Sales, BREAL Zeta

VOLATILITY

What is 'normal' anymore?

Currency volatility is nothing new. If we look specifically at the relationship between Sterling (GBP) and the US Dollar (USD) since the turn of the century we can see enormous changes at play.

Big moves are triggered by major events and it could be said that in the past there was typically one such event per year. But the frequency of major events is ratcheting up. In the past year we have seen Brexit and COVID, as well as the blocking of the Suez Canal. For example, GBP fell c.13% against USD in the fortnight following the Brexit referendum and c.13% in the first 2 weeks of March 2020. The c17% difference between the high and low in GBP/USD interbank rate over the course of the year, underlines the extent of the issue facing UK businesses.

The objective of hedging is to achieve a degree of certainty, which in turn protects a positive target margin. As the pandemic moves into being endemic and supply chains change as the pattern of international trade shifts in reaction to recent major events, businesses of every size are going to have to take currency fluctuations seriously as a key strategic and transactional priority.

Philip Squire acknowledged the consequence of this trend on UK businesses:

> "Any business that trades internationally will face increased currency risk as a key issue due to the ongoing levels of market volatility."

A relationship director at a challenger bank was also quick to highlight the huge shifts in euro versus dollar and euro versus sterling over the past 5 years, prompting a call for renewed urgency and focused governance on foreign currency risk: "We would assume that a performing business over this period with any exposure to international trade would comment that they buy forward or match supply chain to customer base, or to selling point."

While it may be assumed that experienced management teams will have an established hedging policy, that is not always the case, as Robert Wakeford observed: "We looked at an online retailer recently who sourced product extensively from Asia. They did not have a hedging strategy because they thought FX was not a risk since the exchange rates were in their favour. The business had an experienced management team, and a hedging policy would typically be seen in a business that could be impacted by FX movements."

VOLUME

The myth that international business sales volume is the determining factor to hedging strategies for SMEs – and the overwhelming case for financial inclusion.

Mitigating foreign exchange risk is widely seen as an activity centred around medium and large companies with substantial sales overseas.

However, factors such as the international nature of supply chains, lags between the time of manufacture and the time of sale, fluctuating distribution costs and low profit margins can mean that, even in companies with relatively low international dealings, foreign exchange risk can have a disproportionate impact on business performance.

Lenders commented that the requirement for a currency hedging strategy is not dictated by the size of the business or its sector, rather it is governed by the proportion of their exporting and importing activities, in addition to the international composition of their supply chains.

Philip Squire illustrated the increased degree of risk involved with the following example:

> “If 100% of the business is export, and it imports 100%, then they’ve got a huge risk if those aren’t in the same currencies.”

From a lender’s perspective, another important consideration is to have complete oversight of the supply chain, factoring in the time-lag involved. A challenger bank offered their account of trading scenarios from their recent experience: “In situations such as the Suez Canal issue and the COVID lockdowns, where sea freight or air freight are involved, we’re looking closely at the supply chain to see how quickly we can gain access to convert it into sales, to convert it into cash, to pay this back.”

The case for financial inclusion for SMEs, a cohort frequently described by the media as ‘the deserving underserved’, has never been more compelling or more critical, especially in respect of cutting through the complexities associated with foreign exchange and currency risk.

VOLUME

SMEs are the lifeblood of the economy and yet it is felt that they do not have easy access to the expertise, services or signposting they need to protect their businesses and prosper.

Paul Marston explained that for SMEs that are exporting or importing and have exposure to foreign exchange, either directly or indirectly, the key question is not defined by scale alone but more pertinently, 'how does currency risk affect their gross profit margin?'. He added, "If the margin is quite wide, then it's less of a risk but if it's very thin, then it's essential to protect it. For a wholesaler operating on thin margins, a 1% movement in their gross profit margin could make a substantial difference."

Some lenders examine FX risk very carefully as a standard procedure in their credit process during the initial due diligence phase and in subsequent portfolio analysis.

Others, however, who may see a small risk in a high profit margin business, are now re-examining how they approach that exposure.

Ian Duffy said that he comes across a wide variety of sectors that are potentially exposed to currency risk, ranging from professional services and recruitment companies to wine and beer and software as a service (SAAS), where licensing revenue is invoiced to clients. He added that it is possible to identify a potential FX component to a transaction at an early stage: "The first thing we would look at is 'who are the debtors and what currency are the debtors paying in?', or 'what currency have they been billed in versus what is the local currency of the supplier?'."

Robert Wakeford discussed the dynamics of the relationship that exists between margin and currency risk: "If you have a business with skinny margins and a moderate FX exposure then all you need is a small movement in the wrong direction for there to be a pronounced impact on the business."

He emphasised the importance of assessing exposure risk by "running a variety of 'what if' analyses regarding exchange rate volatility to understand how changes will affect business performance".

Consequently, the results of this may impact upon the quantum that companies are able to borrow in the long run, leaving management teams an opportunity to address how they manage foreign currency risk as both an act of good governance and as a strategy to protect their profit margins.

"Most businesses are not there to make money based on foreign exchange movements", observed Paul Marston, "What they are there to do is to generate profits based on their core trading activities and, therefore, an understanding of the risks inherent in their ability to create profits and to repay debts is essential."

VORACITY

The appetite of UK SMEs to understand and embrace hedging strategies.

Very few SMEs have dedicated treasury experts. Therefore, the responsibility for mitigating currency risk naturally falls to the finance director or sits collectively with the Board.

Typically, lenders will look to fund proactive management teams with their fingers on the pulse of the principal risks affecting their businesses. While the MD or FD might not have visibility of the precise solutions they require to manage their currency risks effectively or indeed where to find them, lenders view asking the right questions as a positive indication of the strength of the management team seeking their backing.

From discussions with UK lenders, it is apparent that general awareness amongst SMEs of what is possible in terms of currency risk mitigation is low, as well as the practice of planning and executing FX strategies. Here, the benefit of external expertise is key, as Ian Duffy outlined:

> “Typically, most SMEs don’t have a good knowledge of currency risk, it’s all quite ad-hoc. We, and I think most working capital funders in the market, are not really interested in getting into FX as a service. So, I think that’s always going to be outsourced to a trusted FX partner.”

While Brexit may have raised awareness of currency risks amongst SME business owners, in the past year COVID has dominated the agenda for many. As businesses now emerge from the pandemic and look to progress, education in FX is paramount.

Where access to expert knowledge is not available, experience can be a hard teacher, as Robert Wakeford explained: “There is not a ‘type’ of company that will need education and guidance on FX though it’s usual to see a business that has been impacted by exchange being more cautious of taking exchange rate risks in the future. They seek guidance and get a plan.”

Education for UK SME management teams in currency risk, planning and mitigation is essential, now and in the forthcoming years and should be recognised as a central tenet of financial inclusion. According to Steve Richardson there is a wider issue at stake in the financial education of SMEs: “It depends how pivotal FX is to an SME’s day-to-day business operations, but my experience is that lending is a vital part of their operations and many don’t fully understand it. To that point, we have independent research that shows that 47% of SMEs don’t understand what a personal guarantee is on a loan*, so there’s a long way to go.”

*https://www.reparofinance.co.uk/wp-content/uploads/2021/06/Responsible-lending-report_240521.pdf

VORACITY

A director of a challenger bank anecdotally referred to a client conversation that serves to highlight the need for a closer and more nuanced understanding of the issues and strategies involved: “We have seen FX listed as an exceptional item on a company’s accounts. At that point we would say to them, ‘Are you hedging?’ They’d say, ‘Yes, we’ve a strategy in place.’ and their strategy will often be limited to, ‘When we see it a bit weak, we buy it,’ but what exactly does ‘weak’ actually mean?”

As lenders change and refine their approach to identifying foreign currency risk, they can create an opportunity to raise issues with business decision-makers and push the subject to the fore.

The consensus from lenders is that all but the largest and most experienced SMEs that trade internationally have the requisite knowledge and understanding of currency risk exposure and where and how to mitigate it.

Just as importantly, SMEs do not always know where to source the information, nor do they have a full appreciation of all of the options available to them. Lionel Taylor emphasised that for SMEs having to manage an FX position, this is an issue they should be treating very seriously:

> “Whilst the larger and more experienced businesses involved in international trade understand the need to mitigate currency risk, it doesn’t necessarily mean that they know what solutions are out there.”

He also made the point that where a business may be buying from China and settling in sterling, they may find that they could obtain a better deal by settling in the local currency, CNY: “SMEs and less experienced companies can miss out because they don’t recognise important opportunities in terms of their buying practices.”

Lenders have also seen examples of naivety from several SMEs around exactly how they should price their products and services overseas and whether they can make money exporting, as Paul Marston observed: “There are businesses that think, ‘I can go with my UK price list, convert it using just the exchange rates and that’s what I sell at’, say for example in France. Whereas what they need to do is to work out the domestic Euro price of their products overseas compared to their competitors and then translate that back using an exchange rate to work out what that means in sterling.”

VIRUSES

The impact of catastrophic events, such as COVID-19, and the long-term changes requiring UK SMEs to look at their foreign currency risks.

Foreign exchange (FX) poses a risk to any business with an international trade exposure. Given the overlay of a global pandemic on an environment already facing significant geo-political, policy and transactional risks and its impact is compounded and amplified.

A global pandemic has been predicted for many years. However, as we move from pandemic to COVID being endemic we will see patterns of trade changing over time depending on the outcomes from this dynamic and currently unpredictable phenomenon.

From the discussions with lenders, the message is clear – 'we don't know what we don't know'. The important message is that management teams need to keep agile and informed to react to developing situations.

The true impact of COVID-19 on the markets has not been felt at this stage as it takes time for supply chains to transform and change. That means that trends may emerge over time and that currency risks will need to be mitigated as positions and markets respond. It also serves to illustrate the fact that FX is about far more than the transactional aspects of making payments in foreign currencies. Lionel Taylor remarked: "If a business has been working with a supplier in China for 10 years and they now want to move their supply chain closer to the UK for enhanced management or ESG reasons, they simply won't be able to find a new supplier overnight. They have to research it, work hard to put that new supplier in place and it takes time to make these fundamental strategic shifts."

As a globally linked economy, Brexit notwithstanding, the EU represents a significant and valued trading partner for the UK and will continue to do so. As trade deals are being struck across the globe, the UK is also exploring emerging markets, including trading opportunities with the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). Like China, India is also undergoing a fundamental shift from being a producing economy to a consumer-led economy. As Steve Richardson noted: "This shift will also have an impact on the underlying cost of manufacturing, which is set to increase yet again in line with the living wage, which means there's a chance that more manufacturing will be done in other countries that weren't doing it previously."

The legacy of the pandemic and the complex global inter-relationships of trading partners affect every SME, whether they recognise it or not. It is, therefore, essential to ensure that currency hedging strategies previously only available to larger businesses are now made accessible to all SMEs. In this way, businesses regardless of their exposure or size, can mitigate risk, all the more critical for those that do not have access to treasury resources internally.

VALUE

The opportunity for lenders to UK SMEs to assist their clients in exploring hedging strategies to mitigate foreign currency risk.

There have been many business education initiatives across a wide range of financial topics. The greatest success has been where change is essential rather than optional.

FX management aligns lenders' objectives and those of their clients. In the discussions with lenders, there is an imperative to examine foreign currency risk carefully both from their own and their clients' perspectives. The unique relationship between business and lender offers an opportunity for the subject to be broached proactively, fulfilling an unmet need and strengthening the partnership over a longer term, potentially opening the door to further lending opportunities.

There is a prevailing sentiment that the clearing banks, due to their tiered decision-making structures and the siloed nature of the way they work, cannot provide the level of bespoke support and flexibility that many businesses will require to master risk mitigation for their particular circumstances, especially in the case of smaller firms. It is simply not cost effective for many.

It is also clear that different lenders will have different policies regarding making introductions or offering solutions from external parties. However, the requirement for external guidance from independent FX experts is undisputed.

Lenders are always looking to extend their networks to trusted professionals who can add value and help client business get where they want to be. Steve Richardson commented:

> “Conversely, if a business is not getting the best value out of their FX requirements, that can affect their cash flow, which in turn can materially impact upon their ability to repay lenders. In that respect, getting the right partners works for all parties.”

It is imperative that the financial services ecosystem should be fully aware of and understand all of the FX risks that face SMEs. However, as Paul Marston explained: “If you haven't got that solution in your own kit bag, your own product, then you should know others to whom you can introduce that business.”

Independent lenders pride themselves in taking a holistic view of their individual client's requirements and are both pragmatic and proactive in tackling key challenges as they arise, as Robert Wakeford commented: “We are not our client's treasurer though we do want to understand the risks that not being properly hedged would mean for our clients.”

VALUE

A spokesperson from a challenger bank suggested that in their experience, the ideal time to introduce an external FX specialist is at an early stage: “It’s a far easier conversation to make the introduction to an FX team at the point that a business has signed with us or they have been on-boarded.”

Underwriters, with their years of experience and expertise in credit risk, relationship management, operations and compliance are ideally placed to have risk-based conversations with SMEs. Philip Squire proposed that underwriting best practice would dictate that a lender will “review FX exposure as part of the underwrite, prior to the prospect becoming a client”.

He added, “If it’s material, we would encourage the business to put something in place to manage that risk. Then, depending on what they do or don’t do, it would be something that we would flag and monitor as the relationship continues.”

Lionel Taylor concluded that a key advantage of introducing an independent FX partner is that they “typically bring a greater knowledge and expertise due to their core focus” and added that “We would certainly ask if the business has considered speaking to a specialist to consider if they have the best solution in place today.”

He dismissed the notion held by some SMEs that a non-bank FX specialist is likely to be more expensive than their banks. “It’s a potential challenge but I have certainly found that assumption is not borne out in practice.”

KEY QUESTIONS FOR SMEs

The lenders and advisers interviewed for this paper have highlighted that the narrative surrounding FX exposure is constantly changing, giving rise to a number of key questions that SMEs will need to address to protect their businesses and stay agile:

1. Do you understand your current FX exposure?
2. Has your FX exposure changed?
3. Can you pass FX risk effectively to your customers and how will that impact demand?
4. What are your competitors doing?
5. Do you have line of sight on your currency requirements?
6. Would the business benefit from a degree of certainty on the exchange rate achievable over time?
7. Would you like to try and achieve greater certainty over future requirements?
8. How much should you hedge?
9. How far forward should you hedge?
10. Is there a degree of flexibility required in your currency management approach?
11. How do you manage your approach over time?

THE POWER OF PARTNERSHIPS

Just Cashflow provides SMEs with flexible funding solutions from £10k to £1m. They wanted to add overseas payments to their offering, but in a way that felt like a natural extension of their existing products and services.

They came to Infinity looking for an overseas payments partner that would support their Relationship Managers and SME customers, helping them understand the sometimes-unfamiliar foreign currency markets and adding a human touch.

Working together, the team at Infinity listened to what Just Cashflow wanted to achieve. From there, they set up a series of bespoke processes that ran alongside their existing customer journey and complemented their approach to service.

Just Cashflow's clients experienced a smooth introduction to Infinity's products and services through a dual-branded online portal. And they made sure that Just Cashflow and their clients felt fully supported and were kept up-to-date through all stages of the application process.

Partnering with Infinity, Just Cashflow has been able to provide an extra service for their customers that helps deepen their relationship.

> "At Just Cashflow, we believe that lenders have a responsibility to provide SMEs with more than just money - which is why we have partnered with Infinity to provide SMEs with competitive and efficient overseas payment solutions."

John McLellan, Director, Just Cashflow.

Infinity

Just Cashflow
Partnering with well run businesses

FX HEDGING

The following solutions can all be used together, at different times and for different proportions of a client's exposure, with expert input on how and when they may be executed.

Spot Contracts

The most common form of currency exchange, this solution lets you convert currency immediately at the current exchange rate to enjoy the convenience of making a payment on the same day (where possible).

Market Order

A market order is an instruction to your foreign exchange relationship manager that your business requires a specific exchange rate in the future. As soon as your rate is achievable, it will be secured for the specified amount you want to exchange.

Forwards

If you're making international payments, you can benefit from the security of knowing how much these future expenses will cost by using a Forward Contract. This allows you to fix a price based on the current market rate for buying or selling currencies on a specified date in the future. They are typically used by businesses that have future payments or receipts in foreign currency because it protects both budget and profit margins.

Flexible Forward Contracts

Unlike traditional Forward Contracts, which require a specified date in the future on which the amount must be exchanged using your fixed rate, a Flexible Forward offers more adaptability. This allows you to draw down on your currency at any time up to the maturity date of the contract – as long as you draw down the full amount on or before this date.

Structured Products*

Depending on your business and experience, you may be able to use structured products (e.g., FX options). Some of these products combine the benefit of a fixed rate of exchange whilst providing the opportunity to benefit from advantageous market movements.
Structured products can be an alternative to traditional Forward Contracts. However, they are investment products and carry a degree of risk as a result.

*Structured products (which include foreign exchange derivative products) can carry a high level of risk and may not be appropriate and/or suitable for everyone. If you are in doubt as to the suitability or appropriateness of any product, Infinity International Ltd (IIFX) encourages you to seek independent financial advice.

To many SMEs, finding out about FX can feel like learning a new language. Clear up the confusion with this guide to frequently used FX terms: https://www.iifx.co.uk/forex-terminology/

ABOUT INFINITY

A consistent, structured approach to foreign exchange management is essential.

Foreign exchange risk management remains one of the many strategic challenges faced by SMEs, as well as mid-tier and large international businesses. Established in 2007 with offices in Canary Wharf; Infinity boasts exceptional growth founded on the long-term relationships our experienced team builds with its clients.

We transacted over a billion pound in international payments in 2020 for clients across industries, both locally and globally last year alone. At Infinity, we attribute our success to that of our clients' and the closely interlinked relationship of shared value, together with a prudent risk approach.

Get in touch

In today's volatile and rapidly changing environment, the ability to support SMEs in understanding, quantifying and providing responsive currency solutions is imperative.

For more information on how Infinity can help your organisation with your or your clients' FX requirements, please contact the Corporate Partnerships Team by calling 0203 384 7280.