

Hedging your bets

Managing costs in volatile times: 10 supply chain strategies for a fluctuating currency market

Canadian supply chain managers have enough on their plates without worrying about currency exchange rates.

Or so they thought. Over the past year, the Canadian dollar has plunged over 40% from a modern day high of \$1.10 U.S. in November 2007 to \$0.78 U.S. in October 2008.

Yet the challenge of managing these one-way movements, although dramatic, is relatively straight forward compared to handling some of the wild oscillations we have been seeing lately. October witnessed both the largest ever single-day drop in the Loonie (3.87 cents on October 10, 2008), and the biggest single-day gain since 1960 (3.67 cents on October 31, 2008). This kind of currency volatility can wreak havoc on a business – and could easily be the difference between making a profit or losing your shirt.

Deloitte surveyed supply chain managers throughout Canada to understand exactly how currency volatility is affecting them. The majority said that when the Canadian dollar was appreciating in 2006 and 2007, they responded by increasing their international sourcing of raw materials. Now, in response to recent market movements, many have started to do exactly the opposite.

Financial hedging strategies have traditionally been used to eliminate exchange rate risk from the cost revenue equation. For example, a Canadian manufacturer might hedge a sale to a European customer by purchasing an option to exchange dollars for euros at today's exchange rate – essentially locking in the sales price at the current rate of exchange. With regard to financial hedging, it's interesting to note that while the Bank of Canada has said more and more Canadian businesses are using sophisticated derivatives to manage downside currency risk while preserving upside opportunity, the supply chain function does not seem to be part of the trend. In our study, 75% of supply chain respondents said they do not use currency hedging whatsoever.



Average currency exchange rates



Source: Bank of Canada

Financial hedging techniques can offset the impact of short-term currency fluctuations, thereby reducing near-term financial risk. However, financial instruments to address large currency swings and long time horizons are often difficult or impossible to obtain, or are prohibitively expensive.

To address these larger exchange rate challenges, companies should adopt operational hedging as part of their integrated risk management strategy. Operational hedging mitigates long-term currency risk by giving a company greater flexibility in its supply chain, financial position, distribution patterns and market-facing activities. This enables a business to make swift adjustments to where it manufactures, sources, and sells. An operational hedging strategy includes decisions about the location of production facilities and capacity, sourcing of inputs, choice of logistics network, product design and offerings, as well as choice of markets and how opportunities in those markets are pursued. The objective is to manage cost and revenue sensitivities so as to offset exchange rate risks, while at the same time managing the company's competitive position. Operational hedges can be unique to a given situation or company and can be established in a variety of creative ways. Here are ten operational hedging tips that are particularly relevant to today's highly volatile currency markets.

“This is an unprecedented time of volatility – in financial markets, in commodity costs, and now in currency. Supply chain executives need to focus on improving their supply chain's agility to thrive in this complex business environment.”

Jim Kilpatrick, Partner, Deloitte

1. Understand how currency fluctuations impact your supply chain

Before a company can craft effective operational hedging strategies, it must complete a comprehensive assessment of currency exposure across its supply chain. Currency fluctuations impact industries differently. According to a 2004 Bank of Canada study, 50% of Canadian firms are adversely impacted by an increase in the dollar, 25% are positively impacted and 25% are relatively unaffected. Those companies with endemic exposure to currency fluctuations should give careful consideration to operational hedging.

2. Source and manufacture in the same countries you sell to

The core principle for operational hedging is to preserve margins by structuring your supply chain so costs and revenue automatically stay aligned in spite of currency shifts. The most common way to do this is to manufacture products and purchase supplies in the same country where the final product will be sold. If currency fluctuations drive up labour and materials costs, revenue should rise accordingly – thereby canceling out the exchange rate impact. This can be a particularly attractive strategy for manufacturing companies. Japanese manufacturers have been notable leaders in this area. Since the Yen's sharp appreciation in the mid-1980s, many Japanese companies have built international factories and supply chains that are less vulnerable to exchange rate risks. This approach also has the valuable fringe benefits of reducing transportation costs and fostering goodwill in the local market.

3. Develop a geographically flexible and agile supply chain

A more advanced strategy for operational hedging is to design a supply chain that can be reconfigured on-the-fly to take advantage of currency arbitrage opportunities. With the increase in globalization, some companies have created flexibility in their sourcing, production and logistics networks that allows them to rapidly switch between suppliers in different countries. This strategy can be used to dynamically implement the source-where-you-sell strategy described earlier – particularly when demand patterns are shifting rapidly. Even better, it can also be used to improve your margins by shifting more sourcing to suppliers in countries with favorable exchange rates and therefore lower total cost.

4. Increase investments in markets with stronger exchange rates

Another strategy for capitalizing on currency volatility is to direct sales efforts to markets with stronger currencies. As potential shifts in go-to-market strategy are considered, it is essential that the operations organization be aligned with the commercial organization to ensure that the supply chain is positioned to deliver. Of course, it doesn't make sense to boost your sales and marketing investments in a new country unless you have products that satisfy that country's requirements. If ramping up sales in a new market requires a major product or package redesign – or retooling your production line – this strategy is probably not feasible, at least not in the short term. The key is having universal product platforms that can be sold in a variety of markets, or that can be rapidly tailored to meet local requirements and tastes.

“Our network is balanced against U.S./Canadian currency fluctuations. Within this light, we have little overall exposure and don’t really actively hedge our position against the U.S. dollar.”

Canadian Vice President – Supply Chain

5. Conduct scenario planning that includes currency volatility

Supply chain decisions are often based on total landed cost, as long as basic requirements for customer service and risk management can be met. However, significant currency fluctuations can change the answer. For example, if you recently decided to close a Canadian plant because it operated at a currency-based cost disadvantage, is that decision still a good one given the recent dramatic decline of the Canadian dollar? Although it is essentially impossible to predict where exchange rates will end up, you need to understand the tipping points where key supply chain decisions would shift. This will help you make decisions that are based on sound fundamentals and less subject to the whims of the currency markets.

6. Improve your understanding of product and customer profitability

Today, most companies have only rudimentary costing capabilities based on standard costs that are generally updated yearly, and sometimes even less frequently. Exchange rate volatility, just like commodity price volatility, can invalidate those fundamental cost assumptions. Decisions that were profitable just a few months ago might not be profitable today; yet most companies don’t know for sure.

7. Review your transfer pricing

Given today’s unprecedented currency volatility, it is more important than ever to review your transfer pricing strategies. The primary goals are to price goods appropriately, and to place currency exchange risk in the appropriate business entity.

8. Monitor changes in cross-border activity

With the Canada-US exchange rate shifting so dramatically in such a short period of time, companies and consumers that once purchased from U.S. sites may be able to secure a lower landed cost by purchasing from a site in Canada. Expect your customers to shift their purchasing behaviour to capitalize on favourable exchange rates. Monitor demand patterns closely as this could have a significant impact on how you position inventory in your supply chain to meet customer demand.

9. Review purchase agreements to understand currency risk (and potential upside)

Many purchase contracts are written with clauses to adjust prices in the event of significant currency swings. Now is the time to double-check to determine if your existing agreements provide any opportunities for currency arbitrage, or expose you to significant risk. This is relevant both for buy-side and sell-side contracts.

10. Improve productivity in offshore operations

In recent years, many Canadian companies have capitalized on inexpensive foreign labour to reduce their operating costs. Favorable exchange rates often significantly contributed to the savings. However, with these currency-related benefits possibly drying up, businesses must find new ways to sustain their savings and hit their future cost reduction targets. To that end, a growing number of companies are launching operational improvement programs within their offshore operations. The opportunities can be significant. In addition to reducing costs, operational improvements can improve quality, and reduce cycle times, inventory, and capital investment requirements. These are worthwhile benefits no matter what is happening in the currency markets.

Among the participants in our survey, 56.3% believe the Canadian dollar will strengthen relative to the U.S. dollar over the next twelve months. But no one knows for sure. That’s why it’s so important to make currency hedging an integral part of your global supply chain operation. Operational hedging can help minimize your downside currency risk. And when done exceptionally well, it can even help you take advantage of currency volatility to improve your bottom line.

“The appreciation in Canadian currency certainly made the Canadian marketplace more attractive for U.S. manufacturers, and this was something we had to fight with price concessions. With the depreciating dollar, we should expect to claw back some price in the market.”

Canadian Vice President – Supply Chain

References

“Managing in the Face of Exchange-Rate Uncertainty: A Case for Operational Hedging” – Deloitte Research

“How the Appreciation of the Canadian Dollar Has Affected Canadian Firms: Evidence from the Bank of Canada Business Outlook Survey” Jean Mair, Bank of Canada Review, Autumn 2005

“Summary of the Survey on Canadian Corporate Foreign Exchange Hedging” Bank of Canada Notice – Monday, 27 October 2008”

About the survey

Deloitte recently polled a cross-section of senior supply chain executives in Canada on how the recent market volatility is impacting supply chain operations. The collective responses are intended to provide a general view and do not represent a statistically valid sample.

Respondent profile (n=20)

Industry: Consumer Business, Energy and Resources, Industrial and Life Science Manufacturing

Key contributors to this report:

Lee Barter

Manager
Toronto, ON
lbarter@deloitte.ca
416-601-4853

Chris Lange

Senior Manager
Calgary, AB
clange@deloitte.ca

Contacts

To discuss this topic in more detail and to learn more about how Deloitte can help you manage your supply chain, please contact:

Stephen Brown

Partner
stephenbrown@deloitte.ca
416-874-3154

Jim Kilpatrick

Partner
jimkilpatrick@deloitte.ca
416-874-3231

Claude Dion

Partner
cldion@deloitte.ca
514-393-6548

Kurt Ritcey

Partner
kritcey@deloitte.ca
416-874-3315

This perspective is one in a series Deloitte has produced on managing in volatile times:

It's time to make the call

Taking control in turbulent times

Managing in volatile times

Hedging your bets

Managing costs in volatile times: 10 supply chain strategies for a fluctuating currency market

Breathing room

Ten ideas for squeezing more working capital from your supply chain

See the bigger picture

Managing assets in volatile times: 9 ways CFOs can adapt to changing financial markets

More from less

Building strong business foundations: how CIOs can deliver more value in a volatile economic environment

People at the heart of business success

How to get more value from the right people in volatile times

Contact us to receive the complete series.



www.deloitte.com/ca/supplychain

Deloitte, one of Canada's leading professional services firms, provides audit, tax, consulting, and financial advisory services through more than 7,600 people in 56 offices. Deloitte operates in Québec as Samson Bélair/Deloitte & Touche s.e.n.c.r.l. The firm is dedicated to helping its clients and its people excel. Deloitte is the Canadian member firm of Deloitte Touche Tohmatsu.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, its member firms, and their respective subsidiaries and affiliates. As a Swiss Verein (association), neither Deloitte Touche Tohmatsu nor any of its member firms have any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte," "Deloitte & Touche," "Deloitte Touche Tohmatsu," or other related names. Services are provided by the member firms or their subsidiaries or affiliates and not by the Deloitte Touche Tohmatsu Verein.

© Deloitte & Touche LLP and affiliated entities. 08-1516

Member of
Deloitte Touche Tohmatsu