Mecklai Financial
WHERE RISK MEETS ITS MATCH
AN ISO/IEC 27001:2005 COMPANY

A Classic Dilemma

How to protect both cash flows and the impact on accounts

Our Mandate

We were approached by a leading pharma company asked to conduct a review of its FX risk management operations to assess

- Whether the current strategy used adequately covers the risk on profit margins; could any other alternative provide a better risk/return positioning
- Whether the currently used hedge instruments were suitable under different volatility environment
- How could the natural hedge be optimized and the asset liability mismatch be kept at a minimum

Business context and current operations

- The company was engaged in the manufacture of generics and biosimilars, and had a commercial R&D operation; total revenues were over INR 6,000 cr.
- 75-80% of the revenue was from exports; imported raw material costs were about 40% of the revenue
- Cash flow risk at global subsidiaries was managed structurally, matching local costs with domestic revenue, USD exports with USD labilities, etc.
- Supply contracts were for long tenors and FX risk could not be passed on to customers; thus, any adverse FX movement directly affects profit margins.
- All stakeholders are very sensitive towards ‘FX gain/loss’ in the accounts
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Existing Hedge Strategy

- A fixed hedge ratio was maintained over a defined tenor of risk identification
- Very wide range forwards were used to hedge the exposures over rolling 24 months; while this allowed opportunity capture, it also resulted in open risk (because of the wide range)
- Natural Hedge is managed through EEFC account, on occasions requiring blocking of funds
- Risk was not monitored on a regular (even daily) basis, over the hedging operation

The Solution

Strategic Changes

- Risk Limit: We recommended setting a risk limit (defining the worst acceptable conversion rate) for net exports.
- Risk/Reward-based Strategy: We analyzed the risk/reward of different hedge instruments over the preceding decade. Based on this, we recommended a hybrid strategy, which was a combination of plain vanilla forwards, range forwards and our proprietary hedge model – the selected strategy protected the risk on cash flows over the entire tenor, generated reasonable opportunity gains, and limited the volatility on the P&L

Process Changes

- Natural Hedge: Recommended an optimal approach which ensured that the import payment rate was always lower than the effective export realization rate
- Decision-making: Shifting from the earlier largely discretionary process, we recommended a structured approach to ensure minimal dependence on market views, in line with the company's philosophy
- FX ALM: Recommended SOPs to ensure that (1) the balance sheets of group companies were not cross subsidized and (2) asset liability mismatches between long term FX loans and export value-add were reduced/eliminated

Impact

- **Economic Impact**
  - Recommended hybrid strategy ensured that company does not carry excessive risk to try and capture limited opportunity
  - Since the strategy includes plain forward contracts, it provides better clarity on the future cash flows
  - The strategy also includes the range forwards (with narrow range for better risk protection) which reduces the P&L volatility.
- Operations
  - Structured and process oriented approach in hedge execution in terms of timing/amount of the hedge had made the Treasury function largely personality and market view independent

Thank You