PNC ADVISORY SERIES WEBINAR

How to Protect Earnings from FX Swings

June 18, 2015, 2:00 p.m. ET

Unidentified Particapant: And with that, let's go ahead and begin today's PNC Advisory Series webinar, and it is my pleasure to turn today's call over to our moderator for today, and that is Paul Toth, Managing Director, Foreign Exchange, PNC's Capital Markets Group. Paul, with that, I'll turn it over to you.

Paul Toth: Thank you. Good afternoon, everyone, and welcome to our PNC Advisory Series Webinar, "How to Protect Earnings from Foreign Exchange Swings." Thank you for joining us.

My name is Paul Toth, and I'm a Managing Director with PNC Foreign Exchange, and I will be your moderator for today.

Okay, so, before we get started with our presentation, I wanted to highlight PNC's ongoing commitment to providing market insights, new ideas, and best practices like you're about to hear today. Our commitment is reflected in the types of conversations our bankers are having with companies like yours every day.

It is also reflected in our PNC Ideas thought leadership series, which features a monthly e-newsletter, live webinars, and a dedicated website at pnc.com/ideas.

From brief videos, articles, and economic reports to financial market commentary and webinar replays, we continue to choose topics and formulate our ideas based on the input that we get from you. So, at the end of today's session, please provide the feedback we need to keep focusing on the right information for you and your company.

Okay. So, let's get started with our event. We are excited to have Robert Giannone and Tom Armes as our presenters today. Robert Giannone is a Managing Director in the Foreign Exchange department of PNC's Capital Markets Group. Rob is responsible for managing the foreign exchange sales and consulting teams for PNC's East Coast markets. Presenting with him is Tom Armes, also a Managing Director in the Foreign Exchange area. He has more than 15 years of foreign exchange experience, and has focused most of his career on hedging and accounting issues related to foreign currency.

Together, they will discuss how a strengthening dollar can create a headwind for companies doing business internationally. The recent spike in foreign currency volatility has taken a big bite out of earnings, from both a transaction and a translation perspective. This presentation will help explain these issues and explore strategies for mitigating the currency impact on earnings and cash flow.

We will facilitate a question-and-answer session at the end of the presentation. You can submit questions at any time throughout the presentation by using the questions widget found in the lower portion of your screen.

And so, with that, let me turn it over to our experts, and they'll take it from here. Again, thank you for joining us. Rob, I'll hand it over to you to begin.

Robert Giannone: Thanks, Paul, and I'll also welcome everyone and thank you for joining us here this afternoon.

When we were looking at topics to come up with, we knew that this topic would be especially attractive for people to listen in on, and, frankly, it's probably exceeded our expectations. I think the chart we have up now on the strong dollar really is driving the interest.

So, this is a chart of the dollar index, and, basically you can see, by looking at this chart, the strength of the U.S. dollar over the past 12 months, just by virtue of this index as a measurement. The dollar is about 18% stronger versus the euro. On the chart to the right, it's about 20% stronger.

So, a negative for currencies like the euro, the Australian dollar, and the British pound should mean that the dollar has appreciated by that percentage against those three currencies, and versus the Canadian dollar and the Mexican peso, a positive means the same, that it's appreciated against those currencies. That has to do with the quoting convention in the currency markets.

So, FX. FX, I always tell clients when I speak to them, is like peeling back the layers of an onion, or for those of you with more of a sweet tooth, peeling or eating the layers of a layer cake. There's lots of twists and turns in trying to understand currency impact, and where it hits, in whether it's the equity account, the balance sheet, or the income statement.

Our objective today is to touch on those areas from a business perspective with some light accounting references. The accounting on this can be a little complex, so, we're not intending this to be an accounting-specific presentation, but we will touch on some of the components of accounting, and how the accounting decisions have an impact on the currency — the impact of how the currency impacts your financial statements.

So, this is what the strong dollar has done to some public companies. We've gone out and kind of pulled some quotes, if you will, from some public companies that have been complaining or talking about the impact they've seen in their business relative to the strong dollar.

I can tell you, based upon the conversations, the number of which we've been having with all the companies we deal with, and we work with a lot of private companies as well as public companies, this is a topic that has impacted a lot of companies, both large and small.

So, it's a really relevant topic to be talking about now. I think what often is the most difficult for corporates and investors who invest in corporates to deal with is not necessarily the volatility, if it's slow and steady, but if it's sharp and short, so, it happens in a quick period of time, that's a little harder for investors or owners of businesses to absorb.

And you've seen, in fact, a lot of investors, even mutual funds, if you will, where people are buying mutual funds, internationally oriented indexes are now trying to isolate out the currency impact so that you can just get access to the underlying investment and not have the currency impact. So, that's all kind of been happening in this last cycle of dollar strength.

All right, so, I promised we'd touch on accounting in this presentation a little bit. So, we're going to really, principally, talk about two primary areas, and this is the accounting way to look at FX exposure, if you will.

The first one is transaction or re-measurement exposure, and that has to do with when a company, let's say the functional currency of the company is euros — I'm sorry, or is dollars, and has exposure to British pounds, in a payable or receivable, they have to account for that change, and that's really one of the principal areas of transactional exposure, and we'll get into that a little bit more with an example in a couple of slides.

So, from the time something hits your balance sheet, in a payable or receivable, until the time it's collected, creates that re-measurement risk or that transactional exposure.

I do want to point out, though, for many companies that risk extends much — much earlier than that point, especially if you are going to market with any sort of price lists where your price is a little more static, your risk actually begins, in that case, from the time you publish a price until the time it's invoiced, until the time it's collected.

So, we talk a lot with companies about not only hedging the balance sheet of a payable or receivable, but in advance of that, what we'd call cash flow exposure, as well, which is a forecasted item that also falls under this first category of transaction re-measurement.

The second one is translation. Translation is really — has to do when you have a company whose reporting currency and functional currency, like the parent, is dollars, and it owns a subsidiary whose functional currency is something other than the U.S. dollar, let's say euros.

And when the U.S. company prepares its consolidated financial statements, it needs to translate the financial statements of its subsidiary into its own functional and reporting currency, and that causes a lot of issues, and, frankly, that is the one that has caused the most issue, probably, for a lot of the large corporates, a lot of the quote board we had on the earlier slide is as much this translation impact has been a big headwind in the current strong dollar market.

So, some more accounting terms. I've used a few of these already. So, we'll start with the first one being a local currency. This is the currency that is primarily used in the country of operation. So, a classic example a company, domestic, decides to go international and wants to open an office in the U.K.

And so, the easy decision is just to say, it's in the U.K. I'll have some payroll expenses, I'll make my functional currency British pounds. So, that would be a local currency example.

A functional currency is — again, these are all accounting terms. A functional currency is the currency that you classify for your accounting statements to be recorded in, and typically the functional currency is the currency in which the majority of the economic activity is conducted at the entity.

So, again, in my previous example, if the local currency was British pounds, and you happen to be buying and selling all of your products in the U.K. in British pounds, then, of course, it's natural to say the functional currency ought to also be the British pound, but that's not always the case.

The reporting currency is the currency that's used by the parent company. Typically a parent company's functional currency becomes the reporting currency for the consolidated group of entities on a consolidated basis.

So, these three little terms is really what causes a lot of the problems, the fact that there are differences between these is what causes either the transactional impact or the translational impact on a company's financial statements.

So, there are some rules of thumb, and things you should consider when you're trying to come up with the functional currency decision for an entity. I can tell you in a lot of cases, I don't see companies doing this. I think a lot of times they'll take the decision to say, hey, we're going to start in the U.K. We'll have some people on the ground. Let's make it the British pounds, and that may be okay, but then they mature and evolve and two or three years later, they're doing everything in euros.

Not a great fit when the functional currency is the British pound, and the majority of your sales activities and maybe costs are in something other than the pound. That would be a mismatch, and not the best functional currency for that particular entity.

So, we have here some factors to consider. Obviously, the impact on your sales price, competitive forces and any regular environment, financing activities, and sources of financing activities, whether they be intra-company or access to in-country debt would be a consideration, and finally, you know, what do you expect to do the majority of your operating activities in, would be a good indicator of what would make the best functional currency, because, really, you want to minimize the amount of variability that's occurring because of that accounting decision. That's why it's really important to kind of factor those things in.

Obviously, there's some other considerations regarding the level of autonomy at the subsidiary, any intra-company transactions that are expected, whether financing or transfer pricing related are also important to think about, as well as any expected dividends or repatriation back and forth from the subsidiary to the parent.

So, this is a quick list of some things to think about. You do have the ability, if you already have a functional currency that maybe isn't the best fit now with how your business has evolved, you can change the functional currency. It's not something you can change all the time, but if it's been the functional currency for a while, and maybe not the best fit and causing a lot of FX volatility in the income statement and the balance sheet of the consolidated company, this is something you can look with your accounts to consider changing to a more appropriate functional currency.

You know, a lot of times in FX our first area of defense in trying to reduce volatility is really to reduce the exposure, whether it's by way of netting exposure or by way of this case getting a more appropriate functional currency to minimize some of that volatility that's occurring due to the accounting presentation.

Okay. Here we list some of the key topics of the accounting rules in the U.S. under Chapter 830. I'm not going to go through these in great detail, but these are good places to dig into for some more specific guidance on differing areas of accounting and how it relates to foreign currency.

There's oftentimes lots of good examples here published, as well, to kind of help you better understand the accounting for currency as it impacts the business in different areas of the financial statements, whether it's the income statement or the equity account.

All right. So, here's a real-life example of a payable that might have been booked to be paid. So, this was a payable for one month — for six months at €1 million, and so, this is one of the models we use to help companies try and understand the risks. So, on the U.S. dollar index chart, you saw the movement of currencies, and we talked about the euro appreciation — depreciating against the dollar by about 20%.

So, this is taking that historical moves we've seen in currency pairs, and using a statistical model to try and predict future moves in a currency pair. So, it is statistics. It's not always a perfect science, but it is some objective way to try and quantify a risk you may have, whether it's a risk of a payable, a liability you owe, or, in the case of a receivable, maybe the value of your receivable, how much it can move over periods of time.

So, we use this. It's a model that's built to 2 standard deviations, so, about 95% confidence, based upon statistical analysis, and this is nothing more than charting out what the likely outcomes or what the possible outcomes could be, or the range of outcomes for a payable of €1 million due in six months into the future.

So, you can see the value at risk, or the difference between the least amount it might cost you at $960,500 to the most amount it could cost you, based upon the statistical model, of $1,299,500. So, that's the range of risk that we would talk with clients about to try to quantify what's the cost of doing nothing. What is the potential cost of doing nothing, and what is the potential benefit of doing that?

So, this is one way to frame risk, and we use these models a lot to try and help treasurers and CFOs kind of understand and think about the risk and the potential outcomes on the currency side of things.

So, any time we talk about foreign currency, we always talk about working with clients to try and help them build a hedging policy. It's very — very smart to make sure you have broad discussion at the company around the key considerations of your hedging decision, or non-hedging decision, as the case may be, with regard to the currency markets.

So, this is a whole separate presentation that we do with clients, as well. We kind of took one snapshot of a slide out of the deck to kind of at least illuminate the seven steps that you need to really walk through in order to develop a successful hedging policy.

Obviously, step number two is a real meaty one. That's the one where all the money is, so to speak, figuring out, peeling back those layers on the onion or eating through those layers of the layer cake. That's where all the fun is in trying to really understand how the company is being impacted by currency, whether it's in the cost of goods sold, that cash flow risk I mentioned that exists from the time you price something 'til the time you've generated the invoice, on down to you generated an invoice, you booked the receivable on your balance sheet, and now you have risk from the time you collect it, which is the easiest risk to see, because that risk really is the one that goes in your FX gains and losses, below the line.

So, that's the one that's easiest to see, but that cash flow risk is also very important to think about, especially depending upon how you're going to market and how you're offering a price out in the market, and what that time is from the time you offer a price or set a price 'til the time an invoice is created.

So, we talk a lot with companies about that whole progression of risk across that, from price setting to invoice generation to collection. So, step two is a very important step in trying to understand and quantify the risk to the company.

Then you define your policy and procedures. You look at some strategies to mitigate the risk, establish some roles and responsibilities, and then, obviously, you want to track and measure performance, and also review and adjust your policy. If it's working, great. If there's areas for improvement, you want to adjust and make the policy more impactful to accomplish your objectives.

So, a lot of people ask us what other people are doing all the time, and so, we have gone out and surveyed corporates like yourselves from time to time. This is the results of a recent study we've done or survey we've done with our clients. And, obviously, you can see here, a lot of folks will focus on natural hedging first, so matching of assets and liabilities. People are obviously focused on transactional and cash flow–based exposures, the ones I just mentioned previously, and most hedges we see are probably inside of a year.

I mean, that hedge horizon is really predicated by the confidence of forecasts, and some businesses in some industries are much more conducive to longer-term hedging, because their visibility or production cycle is longer. Some are quite the opposite. Think of a semiconductor business where they can hardly predict how many units they'll sell in the next two months, let alone the next year. So, there are really important things that impact how long we might recommend you go out on the hedge horizon.

So, what's most important? People are, obviously, focused on protecting their value of revenues, minimizing balance sheet impact. That's the one I said is the most easy to see because the change in a balance sheet item from the time it's a receivable booked to collected is the one that goes in the FX gains and losses box, which is the one that's, you know, got the bright, shiny marquee around it. So, it's the easiest one to see.

And then, obviously, trying to manage cost of payables is important, as well.

So, I'm just going to touch on a forward contract. An FX forward contract is — regardless of the type of exposure you're seeing — is the one that's most often used to manage currency risk.

It's the one probably used by 90%-plus of people who are managing currency risk in foreign currency, even those that are also incorporating some sort of option strategy into their risk mitigation program will even include, typically, some base amount of forward contracts.

So, a forward contract in foreign currency is nothing more than a contract we would enter into to agree now on the exchange rate will use between one currency and another in some time period.

So, for example, if you have a liability to pay someone euros in six months, you could work with PNC today to agree on that rate that we would exchange for dollars for euros within six months. And since it's a firm agreement, you basically are fully protected from any adverse moves, which is good. The downside to a forward is you're also not able to enjoy any favorable moves, which is why, in some cases, folks will also consider adding in some options to give some ability to participate in favorable moves.

But, again, forward contracts are used by the majority of folks to manage currency risk. Lots of flexibility since they're over the counter. We can practically agree on any amount and date in the future, and there's also the ability to extend out the date, or bring in the date. So, lots of flexibility with forward contracts. And also, depending upon the type of exposure you're using them to hedge, they're very accounting friendly.

So, the accounting on forwards is light lifting, which is often a consideration when folks are trying to decide which products to use and manage currency risk.

All right. So, with that, I'm going to turn it over to Tom. He's going to tie the volatility we saw in the forward contract into an example he's going to lead off with on slide 14. Tom?

Tom Armes: Thanks, Rob. I don't know if I would consider any of this light accounting. Any aspect of accounting seems to have a little depth to it, and, you know, we're going to give you our perspective on it from a bank perspective, and, hopefully, you can use that as a practitioner.

Obviously, we've talked about transaction and translation creating the risks, whether that's a forecasted transaction in the non-functional currency, or the translation of foreign sub-accounts to the parent. A forward contract, as Rob mentioned, is essentially an obligation that will lock the value of a receivable or payable in at some point in the future.

So, this example shows the impact of a 90-day transaction, denominated in the non-functional currency. In this case, it's a euro receivable, which is the example we've been using frequently.

The initial rate when the transaction was booked is 1.13, so you see there the column where it says invoice. And, as the euro depreciates — which is something that's happened recently — as the euro depreciates, the difference is recorded in P&L, and you can see the P&L adjustment in the middle of the slide there, going down 10,000, going down 15,000, going down 5,000, et cetera.

That — the lower half of this slide shows the impact of using a forward contract. So, the change in value of that receivable is almost perfectly offset by the hedge.

Now, the difference here, you'll notice, obviously, that there's a difference of $300 when you net the two summary sums together, and that $300 difference is essentially the interest rate differential between the two currencies. So, this is a very powerful tool for our clients to hedge their transaction exposure, and, as we'll see later, you can also use these forward contracts to hedge translation risk, as well.

So, one of the things that we see more companies moving towards is looking at their risk on a portfolio basis. You think about how you look at the risk of your investments on a portfolio basis. This is similar to how clients are now looking at their FX exposure.

So, the previous slide was an example of a single transaction, a euro receivable, and how it might be hedged. As I mentioned, many clients are — have multiple transactions denominated in a foreign currency, and rather than manage those on a per transaction basis, they forecast a portfolio of transactions.

Once that forecast of the exposure and timing is created, a hedge program is implemented, and by systematically hedging that on a portfolio basis, clients significantly reduce the volatility between transaction or forecasting periods. If you think about it, if you forecast for a year, you hedge for a year, you come to the end of that year, and you have to layer on another group of hedges, there could be a big gap in that 12 months between when you initiated the first segment of hedges to when you initiate the second segment of hedges.

This impact of dollar cost averaging you're hedging is very powerful. The issue is that many Treasury professionals, when they're looking at this from a portfolio basis, struggle with 100% accuracy on defining and hedging the forecast exposure. So, we see successful companies having a target range of, say, they're going to hedge 80% to 100% of their exposures, and that way they don't get bogged down in the over-analysis of the forecast.

Because, as Rob mentioned, the hedges are really only as good as the certainty of the underlying forecasted transaction, so most customers, most of our clients, tend to target a range or under-hedge slightly from their forecasted portfolio transactions so that they're not over-hedged, and that they have some maneuverability as rates move around.

So, as I mentioned, the layered hedging structure, essentially is a method of dollar cost averaging your hedges, and the averaging effect of this consistent hedging produces a significant reduction in volatility.

In this historical look back, which is a summary analysis that we've done for a lot of customers over the last two and a half years, that reduction was approximately 43%.

The averaging effects also gives you time to react to changing market conditions. So, if the euro weakens, you can change your sales price or if you're buying from Europe, you can potentially renegotiate some of your supply contracts.

You can see the chart here where you've got the blue very jagged chart of the euro spot, and then the green kind of lines that essentially shows what the averaging effect is. And we see a lot of clients moving to this, because ultimately what the goal is, is to help our clients focus on their core business and to try and insulate them as much as possible from some of these — from some of this FX volatility, which essentially winds up in the financial statements, because of the accounting treatment.

So, we're going to move into translation methodologies here, and, as we've discussed, the two primary risks are translation and transaction. We've described the transaction risk. We talked through an example, just right now, and then, obviously, utilizing a forward contract to either hedge a specific transaction or a portfolio of transactions in a layered hedging program.

That same — the same market or currency volatility that can have an impact on transaction has a similar impact on the translation of foreign subsidiary accounts, and many times that's the same method, so, think forward contracts, are used to hedge this risk.

The main issue that causes translation risk is that different rates are used for different financial statement accounts, as you see here. The changes in the value due to the difference in the rates has to be recorded to balance the statement. So, you know, the old saying that the balance sheet must balance.

To further confuse things, two different methods are used to translate the accounts, and we've listed the temporal and current methods here, but first, let's define a couple of items.

Monetary assets and liabilities versus non-monetary assets and liabilities. So, monetary assets or liabilities are those assets that have a fixed value, like accounts receivable. So, if you make a sale for a dollar or for a euro, you expect to receive that $1 or €1 at some point in the future.

Non-monetary assets are those assets that change in value. So, if you — your company made an investment in property, plant, and equipment, that will depreciate over time, so that if you ever liquidated it, that cash — that value might change.

The primary difference between these two methods, between the temporal and current methods, is that the monetary assets and liabilities are exposed to currency volatility with the temporal method, whereas all assets and liabilities are exposed to currency volatility under the current method.

You know, a common question is, which one do we use. So, typically, if the functional currency is the home currency, in other words, if you're a — if your subsidiary is based in Europe and they use the euro as their functional currency, then the current method is used. If the functional currency is not the home currency, or if the subsidiary operates in a highly inflationary environment — think Russia, think Venezuela — the temporal method is used.

There we go.

So, when clients hedge translation risk, they either focus on the stored value or equity, the net investment, or the source of value creation, and that is net income. So, net investment hedges, they benefit from the favorable accounting treatment.

And so, the thought process of hedging translation risk is very similar to that of hedging transaction risk. Essentially, you identify the exposure, you determine the timing. However, due to the accounting treatment, there is, typically, a more deliberate hedging discussion because this could, potentially, create volatility in different sections of the financial statement.

Many companies struggle with fully understanding their translation risk, or they have a philosophical difference, which is something very often, with creating a cash flow event when the hedge settles to mitigate volatility in an equity account, because when translation — when the translation actually occurs, that's go into an equity account.

The impetus to manage this risk is usually driven by investors, either due to valuation, or dividends, or by the likelihood that the equity could be monetized as in a divestiture, also because the translation has an impact. As you roll — again, as you roll it up, the translation of these accounts flows through OCI, which is an equity account, and that could have an impact on equity-based covenants in — you know, in either a bank loan or a bond issuance, or something like that. So, clients are more and more aware of how equity value can impact their covenants.

So, I started to talk, briefly, about the net investment hedge. This is a — this is an example of a net investment hedge. Again, when clients are looking at hedging translation risk, they're either hedging the stored value, the net investment, or they're hedging the source of that value, which is, essentially, the net income.

Net investment hedges, as I mentioned, benefit from favorable accounting treatment, and we have a lot of companies that designate hedges as a hedge of net investment. Essentially the effective part of the hedge is market-to-market through equity, similar to the translation that we've talked about, and then the underlying change in the value of that instrument also goes through equity so they match off in an equity account.

Now, if a U.S. company buys a euro subsidiary, which is something that we see frequently, given the strength of the dollar, they can purchase that entity using debt, equity, or both. And to hedge that initial or ongoing investment, they can utilize this structure and prevent any erosion in value from negative exchange rate movements.

If at some point the asset or the subsidiary is divested, the hedge is unwound, as it shows here, and the value of the hedge and the subsidiary move to the income statement and should offset each other to the degree of effectiveness. Now there are some ineffective portions of a net investment hedge, but for the most part when clients enter into these they match off very well, and essentially hold the value of that asset, whether it's in debt or equity, and they can minimize the impact of currency to that.

We see a lot of this occurring in — where — in the real estate investment trust community, where they — essentially they buy a mall in Europe or somewhere like that, and they know that they're going to sell that at some point in the future, and they're more focused on the value of that asset. They don't want the currency fluctuation. So, essentially what they do is they enter into a net investment hedge, knowing that there's, at some point in the future, they're going to divest, and they're going to monetize that — that equity or that debt that they've put into that entity.

And that's what this is used for. So, again, this is a method for hedging the stored value or the net investment in a foreign subsidiary, and minimizing the translation impact of that equity account.

So, the other one — the other topic is the methods for hedging net in — will ultimately turn into equity. It will ultimately become retained earnings, and client — that, as the source of value for their foreign subs. We have clients that look to hedge that.

Now, the main issue, as we've talked about, is financial statement geography, which is a fancy way to say that the hedges go — any hedge of net income, which because of the accounting treatment, will flow through the income statement, whereas the translation impact will flow through the equity or to the balance sheet.

And so, what our clients try and do, they're trying to either match the geography, meaning move the equity to the income statement, or move the income statement to the equity, or they're trying to minimize the impact that any hedge would have on the income statement.

So, a few examples here. Cash flow hedges — clients will try and find an un-hedged exposure that they can use as a proxy for net income. If the U.S. parent of a euro has some direct sales in euros, it can hedge those transactions as a proxy for net income, because the underlying transactions mimic their long euro asset or net income position.

This is, essentially, moving the geography of the hedge to equity, as this would qualify for forecasted transactions under some of the accounting standards that we mentioned earlier. So, the market-to-market of this hedge would flow through equity.

The second option is somewhat agnostic, vanilla options is agnostic to the geography. This strategy, it doesn't matter, because essentially when you purchase a vanilla option, it's an asset, and its value is either zero or greater than zero.

So, it won't have a negative impact on the P&L, as it's market-to-market, and it will offset, to some degree, the equity — the translation or the equity account, and the changes in value of your foreign subsidiary. Obviously, the downside with a vanilla option is that you have to pay cash, as a premium, out of pocket at the onset, and if this is part of a recurring hedging strategy, you're going to have to set aside a budget for premia, and that's what some of our clients struggle with, as well.

The third option, which has become very popular, is, essentially, the available-for-sale security. So, under international accounting standards, an available-for-sale investment is a non-derivative asset that is designated for sale, which is a fancy way of saying, essentially, your euro sub could buy U.S. dollar Treasuries.

The consolidating effect of that asset because the net income, hopefully, will ultimately be on cash, is immediately converted to the functional currency of the parent. So, the U.S. dollar, if you think about it from a — the sub is, essentially, long euros or short U.S. dollars to the parent, and so, what this does is it creates the opposite effect so that the parent, then, has a U.S. dollar asset or a euro liability to offset their euro asset that the sub has created.

Again, this moves the geography of the hedge to equity so that there is an offset for — between the value of the translated entity and the value of those available-for-sale securities.

The last — the last strategy that we see is, again, agnostic to the geography or indifferent to the geography. As discussed when we talked about the temporal and current methods, revenue and earnings are recorded at an average rate, and so, a company might offset their forecasted revenues with an average rate forward option.

So, the market-to-market value would run through the income statement, but overall, the hedge would minimize the currency impact on net income. And we see this becoming increasingly acceptable for clients that are experiencing large degrees of fluctuations in their equity accounts due to currency. So, they — essentially, they've become — it's become a little bit more acceptable to utilize these strategies to hedge net income, because of the overall strength of the dollar, or the overall weakness of some of these overseas assets.

So, again, these are some tools that we see clients using. All of this is created because of translation versus transaction impact, which, again, is created by the different currencies that are used, whether that's a functional currency or reporting currency, whatever the case may be.

And we've — in this slide, we've laid out a few of these, but, of course, this is something that we would go in depth or in detail with both you and your accounting and tax advisers, as well.

So, with that, I'm going to turn it back over to Rob, and allow him to summarize.

Robert Giannone: Thanks, Tom. I'm going to actually expand a little bit on this accounting issue we've — Tom really talked about with regards to why translation is a bit harder to hedge. And it really has to do with the accounting standards of derivatives under what's now known as ASC 815, formerly known as FASB 133.

That is the section of the accounting that deals with derivatives in foreign exchange, like interest rate products and commodity hedges are considered derivatives in that accounting construct perspective.

And so, really, the reason why translation of a — let's say of a parent subsidiary's financial statements, so parent is U.S. dollar, subsidiary is euro functional — the reason why that's hard to hedge in an accounting-friendly way, frankly, is because the ASC 815 starts out with some purpose tests. And, unfortunately, the hedging of earnings of a subsidiary's functional currency into the parent, is not permissible.

So, that, really, is the rub of the accounting being disconnected. And really, because of that, it, you know, makes a lot of companies get difficult — get — makes it hard for companies to get comfortable with taking on that accounting exposure, which is rather unfortunate, because from an economic perspective, the hedge makes a lot of sense. It's just that the accounting convention isn't really friendly to that type of hedge, because it doesn't meet that purpose test.

So, that's why Tom went through on slide 20, you know, what are some of the alternatives you could use that might accomplish the same objective in a more accounting-friendly way. So, really, that's the issue in a nutshell, is the ASC 815 and hedging translation of earnings is not permissible.

That doesn't mean you can't do it. You can certainly still do it and take that accounting volatility of the mismatch between the hedge — market-to-market going, let's say, going to the current period income statement, and, as Tom mentioned, the change in value of your subsidiary goes to other comprehensive income in the equity account, as well. So, not a perfect match from an accounting perspective, but economically speaking, you're going to be hedged. It's just — it's tough to get over that accounting volatility that's created by the accounting regulations.

So, a quick summary, obviously, the quick pace of strength by the dollar is really what's driven a lot of the cause for pain here in the market. It's funny. People will — when this happens, often will talk to us about is the dollar, like, more — are currency markets more volatile than ever, and, really, they're not. There's been lots of examples over periods of time where the currency markets have become quite volatile.

We sometimes get lulled into a false sense of security that the markets aren't volatile, then we're reminded about volatility. So, really, it has been a long-term issue. There are periods of volatility being lower, as we've seen, or where it's went the other way, leading up into the financial crisis, where if you were long a foreign currency against the dollar, and had it hedged, it look to be a pretty good move until the crisis occurred and kind of evaporated that value, pretty much overnight, when the dollar moved, strengthening, you know, in a very quick pace.

So, for that reason, and for the accounting reasons we talked about, certainly it's fair to say most companies do focus on actively hedging the transactional exposure, whether it's the one that's obvious on the balance sheet, the one I mentioned where the change goes in the FX gains and losses at the time you book an invoice to the time you collect it. But also, most people are also considering or are actively hedging their cash flow exposure. So, that's the forecast of hey, I know I'm going to sell 1,000 widgets and this many euros worth next year, and I want to begin to hedge that now, not when the invoice is created.

So, both those are really the things that most people are hedging today, because, as we mentioned, translation risk is a little more difficult to hedge, the accounting's not as friendly, so, obviously, that makes it a little bit more challenging, but there are some solutions that Tom kind of went through that really do work and are being used by lots of companies today.

The interesting thing, though, is translation and the impact of translation can sometimes be a multiple — a multiple impact compared to transactional exposure. So, especially in periods of sharp volatility, like we've seen, we see a lot of public companies, and they're the ones that we all see, but we also see a lot of private companies who are also being similarly impacted by a bigger magnitude on the translation exposure than they are on the transactional exposure. And, again, it's that short time horizon large move that is really hard to absorb.

So, some companies are — increasingly are hedging this translational risk we've spoken about. We've kind of looked at a bunch of surveys that were done from various folks and kind of come up with about a 15% to 20% estimate of people who are now looking or who are actively hedging kind of the translation risk by using some sort of a derivative, like a foreign exchange forward or some option structure.

Well, we've covered a lot of ground. We've peeled back some layers of that onion and ate some of the layers of the cake, so, hopefully, it was able to be digested. This is a wide-ranging topic that has lots of nuances to it. So, hopefully, we did a good job in kind of walking you through that.

I do want to point out, as mentioned previously, some additional resources that we have available for all of you to go. One is our public website, pnc.com/fx. We have lots of additional information there, webinars and other white papers written about the currency markets, and how to manage currency risk.

Also, we have a separate area of our PNC Ideas site. So, ideas.com/gointernational. Lots of good content there specific to just doing business internationally, from not only a currency perspective, but from a banking perspective, and a trade finance perspective, as well.

I'm going to give you the layman's disclaimer that we are not accountants, although we play them on TV. So, please, with this stuff, we've kind of touched on the surface of a lot of these accounting issues, more to help frame the business conversation maybe between you and your accountants. So, please consult your accounting professionals, as well, with the accounting considerations for hedging.

And with that, I'm going to turn it back over to our moderator, Paul.

Paul Toth: Okay. Thanks, Rob. We would now like to open up the session for questions. As a reminder, you can ask questions using the Q&A window located on your screen. If you do not see the Q&A window, simply click on the Q&A widget, which can be found in the lower center portion of your screen. It's just the words "Q and A," and then that will bring it up and allow you to submit it.

Okay. So, let's take a look at the first question. Gentlemen, the first question is, if currency risks can be controlled with hedges, then why have so many public companies blamed headwinds as reasons for failures to achieve expected quarterly earnings?

Tom Armes: You want me to take that one, Rob?

Robert Giannone: Yeah, go ahead, Tom.

Tom Armes: All right. I think that's a great question, obviously, and it's something that we touched on at the onset of the presentation. It's become somewhat of a buzzword or phrase that, you know, currency headwinds this, currency headwinds that.

And there is a little bit of — I think that there's a little bit of kitchen sink in that if they had — if some companies have had a bad quarter, they've utilized a currency headwind to potentially exacerbate that situation.

But the other thing is that — what Rob touched on is that, essentially, because of the way the accounting rules are structured, it makes it very difficult to hedge net income, and a lot of these companies that are, you know, multi-national entities, they, essentially, are earning a lot of their revenues.

So, if you think about a big company like Coca-Cola, 75% of their revenues are earned overseas. They cannot the majority of that net income. They can do some of it through the proxy transactions that we talked about. They can utilize commodity proxy transactions. They can use proxy transactions of cash flow hedges, but, ultimately, they earn so much revenue that they can't actually hedge it effectively, and so, they have to kind of let it ride.

And so, what you'll hear is, not only currency headwinds, but you'll also hear something called constant currency, which is how they isolate it for an investor or an analyst's perspective, to basically say, this is how we performed when you take out the impact of currency. You know, and, unfortunately, that's not a real-world example, because we live in a world where there are multiple currencies, multiple countries, and obviously relative valuations.

So, I think that you're seeing more — although they're saying currency headwinds, it's because of the fact that they can't — they can't — they can't, effectively, hedge a lot of those translation risks, because of the accounting treatment.

Robert Giannone: I would also add, Tom, to that, [technical difficulty] are actually using some of these strategies, but there's still residual. So, it's hard to find these alternatives that we mentioned, enough of them, in some cases, to Tom's point, when you have 70% of your earnings coming from a foreign currency.

It's hard to find fixes to all of that, so, there's still going to be some residual impact, as well.

Paul Toth: Okay, great. Thanks, guys.

The next question we have asks for you to give an example of when a local currency would not be used as the functional currency.

Robert Giannone: I'll take that one. So, that's a good question. So, I'll go back to, I think, an example I touched on earlier in the presentation was a domestic company decides to go and open an operation in the U.K., and so, makes the decision early on, hey, we're going to be in the U.K., so, we're going to have some folks on the ground we need to pay. So, we'll make the functional currency the British pound. And then, as the company gets — goes to market and begins to sell products, and maybe even build products, actually, as it turns out, they're doing more of that, or the majority of it, in euros, even though, for maybe tax reasons they're in a low-tax U.K. jurisdiction, and kind of chose the U.K. for that reason, and thought because they had people there, they would make the functional currency the British pound.

But in reality, it probably would have been a much better fit to pick euros in this example, and manage a much smaller disconnect between a little bit of operating expenses they had in payroll in the U.K., and pick a functional currency that better aligns with the primary economic currency of their operating activities, which in my little example here was the euro.

So, that would be an example of where, you know, don't just pick the functional — don't pick as your functional currency, the currency where you decide to set up shop of that country.

Tom Armes: Yeah, and the other thing I would, too, is something that we mentioned briefly was the inflationary environment. So, when you have entities that are doing business in highly inflationary environments, a lot of times they'll opt for — or in a country where the currency is closely pegged to another currency, like the U.S. dollar — sometimes the companies will opt for that pegged currency, or an alternative currency to that highly inflationary currency.

Paul Toth: Okay. So, then, switching gears a little bit, the next question says is translation risk only a concern for large, publicly traded companies? Do you see privately held companies also hedging this type of risk?

Tom Armes: This is Tom. I think the answer to that is that any company that has, you know, an asset overseas, more than likely, that's a subsidiary. It doesn't necessarily have to be a publicly held company. Any entity that has an asset overseas should be concerned with translation risk. Whether or not they hedge that, that's going to be something that's determined by the management team, but, essentially, if they have an equity investment in that entity, and they potentially are going to dividend to the owners, even if it's a very small company, from that equity position, they're going to be concerned about the relative value of that euro sub in this example, or if they have a debt investment, they're going to be concerned about the repayment of that debt, at some point in the future.

So, even small companies that have overseas operations should understand this and be aware of it, and if — as it gets closer to, potentially, a cash event — whether that's they sell it as a divestiture, whether that's a dividend, whether that's a repayment of debt, as it gets closer to a cash event or a monetary event, then they might consider hedging it.

So, this isn't isolated to just publicly traded companies. It is isolated to companies that maintain some asset or some operations overseas.

Paul Toth: Okay. Thanks, Tom.

The next question says, what's the difference between over-hedged or under-hedged? It would seem that they would both have the same type of impact. Can you elaborate?

Robert Giannone: Yeah, it's a good question. I'm going to answer that from two lenses. One is being over-hedged from an accounting perspective, and specifically a hedge accounting perspective, if you're electing some of the deferral accounting under the ASC 815 I mentioned previously, which is the accounting standards for derivatives accounting, there are some pretty bad accounting consequences if you find yourself in an over-hedged position relative to — in a nutshell, what hedge accounting allows you to do, or deferral accounting allows you to do is, if you're hedging a forecasted transaction that hasn't yet even occurred, obviously, there's not nothing yet recorded or any financial statement except for the hedge itself.

And so, under accounting rules, you have this hedge that has a market value, and that market value changes. You have to record the value of that change in your income statement if you do nothing. If you elect deferral accounting under ASC 15, you can defer that gain or loss, into the equity account, and recognize it in your income statement, along with the underlying transaction, when it gets booked, and it becomes, let's say, a receivable and a collected item.

So, when you use deferral accounting under hedges, and you find yourself in an over-hedged position, you have to kind of take those — let's say, those losses that you've kind of put away off the income statement into this equity account temporarily, you have to recognize that in the current period income. So, when you're using deferral accounting, you want to be particularly sensitive to not finding yourself in an over-hedged position.

Generally, when we're talking with clients about coming up with a hedging policy, we talk a lot about how much to hedge based upon lots of factors, whether it's things like the predictability of the future exposures given past. Some businesses are better able to do that than others.

We also talk a lot about what additional or other risks the business has. So, obviously, companies that have narrower margins and high operating leverage and lots of debt, generally, we recommend hedging a bit more on the higher end of the percentage terms to take some risk off the table that you can actually control.

So, we look at all those things. Generally, we try and recommend, as Tom mentioned earlier, folks to always leave some cushion, so, you don't find yourself in an over-hedged position, and we generally, you know, start out in the 75% to 85% range, and then we kind of look at other factors specific to the business, and their ability to forecast to fine-tune that.

Paul Toth: Okay. Well, we still have a lot of questions, but we are out of time. For those of you who have written in questions to us, we will try to answer those directly to you, offline. We have a listing of who sent them, and should be able to do that.

So, I would like to thank Robert and Thomas for a great presentation today. You both provided really great insight and perspective. We would especially like to thank all of the people who have dialed in. We appreciate your attendance.

So, a PDF of today's presentation, as well as a CTP certification credit, and a recent investment outlook update, is available for you to download from the green resource listen file, order widget in the lower center portion of your screen.

Okay. You will also see a link to a short survey on your screen. Again, your feedback is important to us, and we greatly appreciate your thoughts on today's sessions and presenters.

This concludes our presentation today. Thank all of — thank you all for joining.

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