

Currency Hedging. The case study Nestlé Suisse SA



Oana Toader¹, Florian Homburg¹, Christopher André¹, Tânia Teixeira², Adalmino Pereira³

¹ISCAP – P Porto

²ISCAP – P Porto; CEO and finance assistance specialist

³CEOS Member and ISCAP – P Porto teacher

ABSTRACT: Globalization has opened a world market that allows us to trade. These exchanges are now counted in billions of Swiss francs (CHF). (Grossbard, 2023) Indeed, many companies buy and sell currencies every day in order to settle their transactions. For many companies, the price of foreign currencies has an impact on their results. This impact is not controllable and can be very volatile and unpredictable. Companies are all looking to minimize the uncertainty of foreign exchange losses and therefore find the best ways to avoid such accidents. Several means exist such as the technical strategy of currency hedging. This paper will illustrate how an international company works when it comes to forwards. There will be a fictional case study that will show the impact of the war in Ukraine in currency hedging.

KEYWORDS: Hedge; Financial Risk; Derivatives; Nestlé

1. INTRODUCTION

In our economy, we have an intermediate medium of exchange which is money. We work to acquire it because it is a safe way to pay for goods and services. Money is used all over the world and most countries have a national currency or an international agreement for its use, such as the Euro. Its price is defined by interest rates, by supply and demand and above all by the confidence brought to the economy of a country. Money is volatile and therefore has no defined price. It is an image of the country's economy. For example, Zimbabwe has suffered years of hyperinflation due to the land reform imposed by the government, which violated human rights. Thus, Western countries have, in a way, boycotted Zimbabwe, which has led to a financial crisis. If we had Zimbabwean dollars, the next day they were worthless, so the price of living increased every day. (Zimbabwe, 2022) This is obviously a very special case, but the price of a currency fluctuates every day and since we live in a globalized world, the impact on the economy can be very important, negatively or positively.

Hedging

A hedge is a contract aimed at reducing the risk of adverse price fluctuations of an asset. A hedge can be compared to an insurance policy. It ensures that an asset is locked in at a predefined price in the future. As a result, the variation of its price will not be considered and therefore the risk of loss disappears but so does the gain. If you own a house, you usually buy flood insurance. You will reduce the financial risk of a flood by paying a certain premium. This way, at the time of the accident, you are normally covered. Of course, there may never be an accident and you will lose out. Nevertheless, most people prefer to be insured in order to avoid paying a huge sum in one go. Hedging works the same way. It is necessary to make deals with banks to cover risks that we want to avoid. (Chen, 2022)

Forex hedging

Forex hedging is the strategy of protecting against or reducing the loss of money when trading foreign currencies. Thus, when a company uses forex hedging, its objective is to minimize the risk of losses or gains due to currency fluctuations. (Jageron, 2022) To do this, it will create contracts with financial institutions through which companies will have the right or duty to exchange their currency at a defined rate in the future. Forex hedging is therefore the insurance of avoiding a loss in case of a fall in the rate, but at the same time, one renounces any potential gain in case of a rise in the rate. (Chen, 2022) There are several instruments available to carry out this strategy in the foreign exchange market. Indeed, traders have three main instruments at their disposal: forward hedging, currency options and future hedging

In the foreign exchange market, a forward contract is a contract that fixes the price at which a person or company will buy or sell a currency at a future date. The rate used at the maturity date (the moment the deal will be executed) is equal to more or less the rate at the time of the deal as it should include the central bank rate and time. For example, today on March 15, we can make a deal to exchange our currency at today's rate (including central banks rate and time) on a chosen date, for example July 15. (Dhir, 2022)

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The example at a fictitious rate below figure 1 shows that the rate used at maturity is not the same as the spot rate (market rate on the day of maturity). The difference between the two rates will either be a profit or a loss.

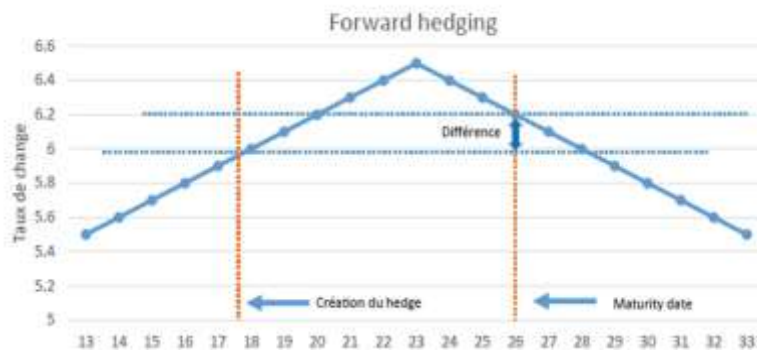


Figure 1. Christopher André currency exchange

Basic operation of the forward

Company A makes a deal with a bank to exchange the foreign currency it receives at a rate of x. On its side, the bank will make the deal and resell the currency it will buy from company A. In this way, it will not bear the exchange rate risk. For this service, the bank will add a commission to the exchange rate. It will simply act as an intermediary between the two parties. Therefore, if company A loses money, company B will gain money and if company B loses, then company A wins.

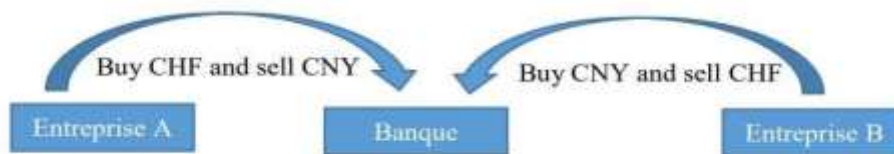


Figure 2. Christopher André basic operation of the forward

Forwards gain

If the forward rate is higher than the spot rate, the company will win.



Figure 3. Christophe André Forwards gain

Forwards loss

Forwards loss

If the spot rate is higher than the forward rate, the company will lose.

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Figure 4. Christopher André Forwards loss

Positive points of forward currency hedging

- The company knows exactly how much it will receive or pay
- It is a way for the company to make the future predictable
- It is a customizable and flexible instrument
- There is a lot of liquidity (ability to buy or sell quickly) in this market

Negative points of forward currency hedging

- The company can lose money on the exchange rate if it is unfavorable
- The company cannot cancel a deal because it is committed (even in case of default of its debtor)
- The company is alone against its counterparty

2. CASE STUDY NESTLÉ SUISSE SA

Nestlé (mother company) hypothetically wants their sub companies to follow as much as possible their budgets and as well avoid ineffectiveness cases. They set up a hedging scale at 75% in order to avoid ineffectiveness with a 6-months policy which is a no-risk policy.

Forex hedging at Nestlé

Nestlé is a publicly traded company, so it must provide projections to its shareholders on the outcome of its activities. In order to deliver them, it must respect its budgets. One of the ways to do this is to implement forward currency hedging. Nestlé, being an international company, makes payments around the world in various currencies. They pay and receive millions of CHF per month and thus buy and sell huge quantities of currencies. As a result, it is subject to large exchange rate risks that can affect the monitoring of budgets. Nestlé is a company that has its HQ based in Switzerland and has a geographic structure. This means that Nestlé have sub companies such as Nestlé Suisse SA. (Nestle, Nestlé sharpens geographic focus, creates Zones North America and Greater China, 2021)

Nestlé Suisse SA

Nestlé Suisse SA which sells different products such as Nescafé, Nesquik and so on, is an entity of Nestlé based in Switzerland whose operating currency in this case study in Swiss francs. (Nestle, Nos marques de produits Nestlé, n.d.) It has relationships with many different countries around the world. It makes and receives payments in millions of Swiss francs each month. In order to follow Nestlé's no-risk policy and to respect forecasts, Nestlé Suisse SA uses forward hedging. This process allows Nestlé Suisse SA to know exactly what counterparty it will receive or pay for the agreed transactions. In this context, Nestlé Suisse SA has set up a 6-month benchmark as provided by the mother company, i.e., it concludes deals for the commercial transactions of the next six months. In concrete terms, it sets today the rate it will receive in six months. The purpose of the 6-month benchmark is to allow for operational adjustments if the price of the Swiss Francs suddenly increases or the price of the Lempira decreases. For example, Nestlé Suisse SA could increase the selling price of its goods or find alternatives in its purchasing or production process. They might hypothetically use Nestrade SA for international trading services.

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Nestrade SA

The purpose of the company is: to provide purchasing and procurement services, in particular the management of strategic procurement groups and markets, including the management and development of supplier relationships and the definition of procurement policies and procedures; to conduct sales and procurement activities, in particular to buy and sell, in Switzerland and abroad, all products, raw materials, packaging, equipment and services, in the fields of food, nutrition, health, wellness and related industries on behalf of itself and its affiliates, to carry out financial hedging, foreign exchange and any other related financial activities or services to take an interest, in any form, in all similar enterprises, to undertake any business which may, directly or indirectly, further the purpose of the company and, in general is, to undertake all industrial, commercial and financial or real estate operations which may imply the corporate purpose of the company (for full purpose see. articles of association). (Opencorporates, 2022)

Hypothetical case with a war in Ukraine for example

As one of the biggest Nescafé factories is based in Switzerland at Orbe, Nestlé Suisse SA will need to buy coffee beans from around the world in order to manufacture it. As a result, they will be exposed to Forex risks as they will trade internationally. They will ask the expertise of Nestrade to manage these risks and elaborate the plan. Nestlé Suisse SA will send to Nestrade forecasts and Nestrade will execute the deals needed. Nestlé Suisse SA also wants to avoid a case of ineffectiveness. Ineffectiveness is the fact that Nestlé Suisse SA does not receive the full amount of the forecasted amount at maturity date.



Figure 5- Pierre Boss « Nescafé » <https://concept-consult.ch/en/architecture/nescafe-2/>

Profit and loss and currency fluctuation due to war in Ukraine

The first step that Nestlé Suisse SA had to do is a forecast of their sales. Indeed, when they know their total sales, they would be able to know the amount of coffee beans they need. They will work closely with the marketing department. The second step after they forecasted the sales is to work with Nestrade which will execute the deal with the bank that Nestlé Suisse SA needs. Then if they have a policy of hedging 6 months in advance, 6 months later the deal will be executed.

The profit and loss would be calculated as follow:

Forward rate at maturity date

- Spot rate at maturity date

= Profit or Loss at maturity date

A typical scenario is when Nestlé Suisse SA forecasted 1 year in advance their sales. If they know that they are going to sell a quantity of coffee worth 26,750,000 Lempira of cost of goods sold, they know that they need to buy coffee beans worth 26,750,000 Lempira. It is important to note that in this scenario, the forward rate will equal the spot rate at the deal date (date at which Nestrade negotiates a deal with a bank). This scenario does not consider central banks inflation to determine the forward rate.

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Franc suisse vers Lempira

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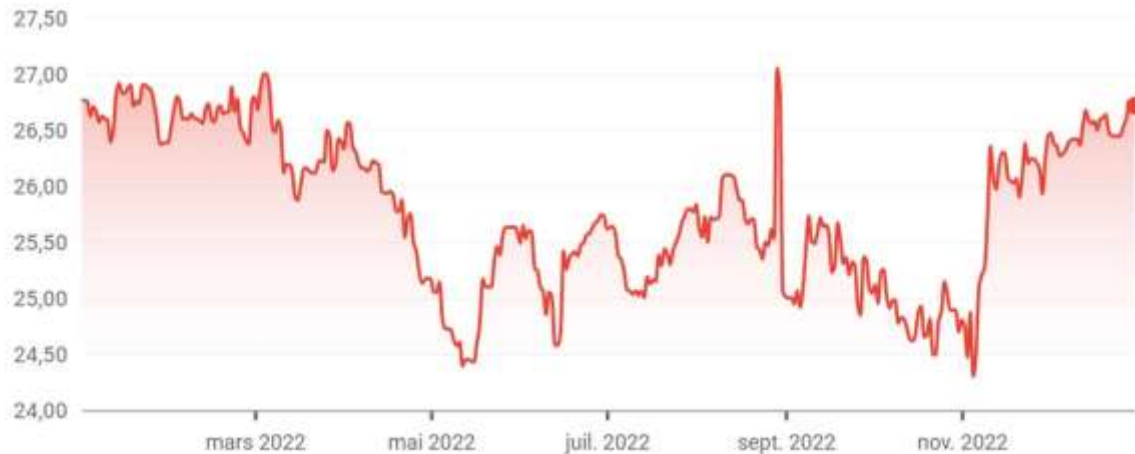


Figure 6. Franc Suisse to Lempira

<https://www.google.com/finance/quote/CHF-HNL?sa=X&ved=2ahUKewjniNnc8qP8AhVZ7LsIHQHFAm0QmY0JegQIARAZ&window=1Y>

Figure n°6 shows a huge fluctuation in the currency rate. At the beginning of the year, 1 CHF was equal to around 26.75 Lempiras but at the end of May, 1 CHF was equal to 24.5 Lempiras. This was due to the war in Ukraine. The Swiss Francs as a “safe” and strong currency, when the war began, investors bought a lot of Swiss Francs and as result, the Swiss Franc gained a lot of value. On the other hand, the Lempira which is not a strong currency lost a lot of value. At the deal date on the 1st of January Nestlé Suisse SA asked Nestrade to elaborate a deal with a bank.

Deal date

Nestlé Suisse SA has, as explained, a hypothetically 6 months hedging policy. In this scenario, the forward rate and the spot rate at deal date are the same. Nestlé Suisse SA on the first of January knows that they need coffee beans worth 26,750,000 Lempira. In order to follow with the cash flow and to prevent any financial risk, they ask Nestrade to elaborate a deal with the bank. Nestrade would approve and elaborate a deal at 75% of the 26,750,000 in order to avoid ineffectiveness. Nestrade will hedge 75% of this amount which results in exchanging 750,000 CHF to 20,062,500 Lempira.

Maturity date:

Nestlé Suisse SA will have to pay an amount of 26,750,000 Lempira for the coffee beans, and they know that they will exchange 750,000 CHF to 20,062,500 Lempira. Therefore, the only risk they are taking is the acquisition of 6,687,500 Lempira. 6 months later (spot rate is 24.5 at maturity date), at maturity date, Nestrade executes the deal and gets 20,062,500 Lempira. They also exchange 272,960 CHF to get 6,687,500 Lempira in order to pay for the coffee beans.

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Figure 7. Franc Suisse to Lempira

<https://www.google.com/finance/quote/CHF-HNL?sa=X&ved=2ahUKEwjniNnc8qP8AhVZ7LsIHQHFAm0QmY0JegQIARAZ&window=1Y>

Forward rate at maturity date	26.50	20,062,500
- Spot rate at maturity date	24.50	18,375,000
= Profit or Loss at maturity date	02.00	1,687,500

Nestlé Suisse SA would have a gain in this scenario of 1,687,500 Lempira.

Positive points of forwards in Nestlé

- **Non-standardized contracts:**

Forwards type contracts can be customized for each contract taker. Nestlé can define the contracts that suit him best with the bank according to his financial capacity.

- **Liquid forwards market:**

Because the market is so liquid, Nestlé Suisse SA can enter into a contract at any time if needed. The futures and options markets are not as fluid and therefore do not provide the same flexibility.

- Reduction of the risk of a currency loss
- Additional time to adapt business strategy in case of abrupt change - Alignment to budget

Negative points in forward hedging in Nestlé:

- A deal cannot be canceled but swapped
- Risk of ineffectiveness
- Loss on spot rate at maturity date

3. CONCLUSION

Hedging is a complex and difficult strategy to understand. However, the variation of supply and demand, and the political and economic stability of one's country, are elements that do not allow one to predict the future. The risks of exchange rates are present, we cannot guess if the price of a currency will increase or decrease. Many crises such as the subprime crisis are examples of economic instability. Therefore, Nestlé is looking for strategies to avoid finding itself in an uncontrollable situation. Forward hedging is one of many instruments that allow us to hedge against any loss or gain and to know in advance how much money Nestlé Suisse SA will have to pay or receive. In addition, the X-month benchmark allows you to adapt in a crisis. Of course, the theory does not correspond exactly to the practice because the realization of the budgets, the swaps, the different deals for a forecast, the hundreds of revalued invoices, the gain and loss of the hedge not accounted for in the P&L at the time of the revaluation and the macro-economic events make the process even more complicated to understand.

In this case study, there is a profit, but Nestlé Suisse SA was not gambling they just wanted an insurance. Nestlé Suisse SA made a profit with this forward operation. This profit could be as well debatable as Nestlé probably set up the benchmark of X-month policy and the guidance to follow. In accounting, on the one hand, Nestlé Suisse SA would have been profitable which could off impact the bonuses of the company. On the other hand, another market could be impacted by the forward policy and as a result lose a lot of money and receive less bonuses for example.

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