FX Hedging Memo – Scenario 1: U.S. Solar Equipment Importer

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Executive Summary

The firm expects to receive €4.5 million in one year from a European customer, creating exposure to the EUR/USD exchange rate. At today's spot rate of 1.1642, the receivable is valued at approximately $5.24 million. However, the forward market rate of 1.0875 and interest rate differentials (USD 4.11% vs. EUR 2.15%) suggest that the euro may weaken, which could reduce USD proceeds by several hundred thousand dollars. This proposal evaluates three hedging strategies, forward contracts, currency options, and money market hedges, and develops a quantitative model to compare their outcomes. The expected result is a structured recommendation that balances certainty, cost, and flexibility, enabling management to make an informed hedging decision by October 24.

Background & Objectives

The company's receivable of €4.5 million, due in one year, exposes it to foreign exchange risk. If the euro depreciates against the dollar, the USD value of the receivable will decline, reducing expected inflows and creating volatility in financial forecasts. This matters because it could negatively affect profitability, liquidity planning, and shareholder confidence. The primary objective of this proposal is to safeguard the USD value of the receivable through appropriate hedging. A secondary objective is to provide management with a structured, quantitative framework for comparing hedge alternatives, ensuring that the decision aligns with both current market conditions and the firm's overall risk tolerance.

Methods

The firm will evaluate three hedging strategies, forward contracts, currency options, and money market hedges, using current data. Forwards provide certainty but no upside, options protect downside with a premium cost, and money market hedges lock in a synthetic rate but require liquidity. A spreadsheet model will include inputs and outputs, with sensitivity analysis, comparative charts, and an AI prompt to generate transparent, labeled formulas.

Limitations & Next Steps

The analysis assumes stable interest rates and market conditions, though unexpected shocks could alter outcomes; option premiums reduce net proceeds, and money market hedges may constrain liquidity. The next step is for the finance team to build the Stage 2 spreadsheet model with inputs, outputs, and sensitivity tables, followed by Stage 3 stress testing and scenario analysis. Based on current forward pricing, the forward contract secures about $4.89 million, offering certainty, while options preserve upside at a cost, and money market hedges eliminate risk but tie up funds. The recommended strategy is hedging 75% with forwards and 25% with options.

References

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