Document 8 of 14.

Business Week

October 26, 1998

SECTION: THE CORPORATION; CURRENCIES; Number 3601; Pg. 74

LENGTH: 1777 words

HEADLINE: PERILS OF THE HEDGE HIGHWIRE

BYLINE: By **Peter Coy** in New York, with De'Ann Weimer in Chicago and Amy Barrett in Philadelphia

HIGHLIGHT:
Locking in exchange rates isn't always a great idea

BODY:
As a company that gets more than half of its sales and profits in foreign currencies, Minnesota Mining & Manufacturing Co. is exquisitely sensitive to fluctuations in exchange rates. When the dollar rises, profits fall. Yet 3M doesn't use hedges to protect against currency fluctuations. In August, the maker of Post-its and Scotch Tape announced that the dollar's rise had cost the company $ 330 million in profits and $ 1.8 billion in revenue over the past three years. The no-hedging policy has analysts and investors in an uproar. "They have lost all credibility with Wall Street," says Jack L. Kelly of Goldman, Sachs & Co.

But is 3M really so dumb? Not according to academics, consultants, and a slew of other big companies that choose to hedge very little or not at all. Companies ranging from Kodak to Deere to Exxon argue that currency fluctuations help profits as often as they hurt them -- and that hedging simply doesn't pay. NOT CHEAP. The reason: Big companies can generally ride out negative currency moves without having to cut back on, say, capital spending or research and development. Moreover, hedging isn't cheap. And though the costs might be worth overlooking if hedging generally worked, studies show that hedges often fail at their main aim: cutting volatility of sales, cash flows, and earnings. "In many cases, the best solution is simply not to hedge," says Tom Copeland, a corporate finance consultant at Cambridge (Mass.)-based Monitor Co.

Currency hedging has emerged as a front-and-center issue because of the recent surge in exchange-rate volatility. Asian currencies and the Russian ruble have crashed over the past year. And after soaring 70% against the yen in three years, the dollar slid 15% in a mere day and a half early this month. It's little surprise, then, that many companies hedge. The University of Pennsylvania's Wharton School and Canadian Imperial Bank of Commerce found in a recent survey of 400 U.S. companies -- many among Corporate America's largest -- that one-third do some kind of foreign-currency hedging.

The standard argument for hedges is increased stability. "We're trying to reduce volatility in earnings and cash flows," says Lori A. Walker, director of global financial risk management at controls supplier Honeywell Inc., which gets 40% of its business outside the U.S. When effective, the decrease in volatility means that companies can smooth out cash flow, making it easier to plan spending. Lower volatility also reassures lenders and investors, and makes forecasting year-ahead results for Wall Street easier.

Drug giant Merck & Co., for instance, hedges some of its foreign cash flows using one- to five-year options to sell the currencies for dollars at fixed rates. Merck argues that it can protect against adverse currency moves by exercising its options, or enjoy favorable moves by not exercising them. Either way, the company aims to guarantee that cash flow from foreign sales remains stable so that it can sustain research spending in years when a strong dollar trims foreign earnings. "Volatility is here to stay," says Judy C. Lewent, Merck's highly regarded chief financial officer. "We pay money for insurance to dampen volatility from untoward events."

But many well-established companies see no need to pay for protection against currency risk. Copeland points out that many choose to cover the risks out of their own deep pockets, similar to the way they self-insure against fires and floods. Take 3M. In spite of currency-related losses over the past three years, the company has steadily increased its R&D budget, from $ 883 million in 1995 to $ 1 billion this year. "If you look at the cost of hedging over the entire cycle, the hit to your cash flow is incredible for buying that insurance," says Janet L. Yeomans, 3M's vice-president and treasurer. "We would prefer to find operating solutions to those problems."

Indeed, hedging itself eats into profits. A simple forward contract that locks in an exchange rate costs half a percentage point per year of the revenue being hedged. Other techniques such as options are more costly.

And they don't buy much. A 1996 study that Copeland co-wrote while at McKinsey & Co. concluded that most hedging actually doesn't significantly cut volatility. Using 10 years of earnings statements from 198 large U.S. companies, the study found that only one could have reduced its annual volatility by more than 20% through hedging.

The reason is that fluctuations in the underlying business can spoil the hedge's effectiveness. Take the case of a U.S. company exporting to Japan. Assuming local sales in yen remained stable, a stronger yen would be expected to increase the outfit's revenues when translated into dollars, while a weak yen would normally lead to lower revenues in dollars. In either case, a hedge would gain in value if the yen fell, and vice versa. The goal: Sharp ups and downs in earnings would smooth out.

But if the company's local sales happen to weaken at the same time -- say, because of a slowdown in Japan -- then hedging against a stronger yen can actually exacerbate volatility. Not only will revenues from Japan fall in terms of U.S. dollars, but the hedge will lose money as well. In fact, that's probably happening right now to some companies that hedge against the yen.

Indeed, it can be so hard to get hedges right that many companies have decided they're not worth the trouble. George M. Fisher abandoned Eastman Kodak Co.'s aggressive hedging strategy shortly after becoming CEO in 1993. He concluded that hedging wasn't necessary since the ups and downs of currencies would even out in the long run.

At present, that's an unpopular position. On Oct. 13, Kodak announced that currency translations would cost it some $ 384 million in revenue and 30 cents a share in profit for the year. In its aversion to hedging, says analyst Michael W. Ellmann of brokerage Schroder & Co., "Kodak is so conservative as to be aggressive." But Harry Kavetas, Kodak's CFO, says the tide is turning: The newly lower dollar should add a penny to fourth-quarter earnings per share.

For companies with a strong belief in hedging, the sustained rise in the dollar over the past several years proved a serious test. Coca-Cola executives have bragged to investors that by using options, they can limit the negative impact of unfavorable currency swings on earnings to 3% annually over the long term. That hasn't been the case, however, in 1998. The company warned last December that currency moves would knock 6% off expected 1998 profits and has since boosted the estimate to 9% to 10%. PROFIT HIT. Two-year hedges taken during 1995 on the Japanese yen and German mark did help keep Coke's profits up temporarily. But when they expired last year amidst a significantly stronger dollar, the transition as foreign earnings were translated into dollars was far more abrupt. That's hardly consistent with the idea of smoothing earnings. Worse, now the hedge is hurting profits. Well before the yen's recent rise, Coke set its dollar-yen rate for the year.

Surprisingly, many companies that hedge don't seem to have thought much about how they perform. The Wharton-CIBC study found that 44% of the companies that hedge have no yardstick to measure if their program is succeeding.

Just as problematic, many seem to be using hedges to speculate on currency movements as well as to guard against them. In the Wharton-CIBC survey, some 26% of the companies that hedge say they sometimes "actively take positions" in currencies based on their market views, and an additional 6% do so frequently. That's little more than a euphemism for speculation. "I'm amazed how many firms respond positively," says Gordon M. Bodnar, an assistant professor of finance at the University of Pennsylvania's Wharton School and co-author of the study. "NATURAL." Given the mixed record of much hedging, Bodnar and others believe that many companies do so principally to simplify corporate budgeting or to please Wall Street. Even if the hedging doesn't reduce the true volatility of earnings, it might improve the ability to forecast them over the short term. "Predictability and consistency of earnings play a big part in valuations," says William Pecoriello of Sanford C. Bernstein & Co., who follows Coke.

In fact, some companies that hedge acknowledge that short-term planning is what dictates hedging policy. Why hedge when the ups and downs of the dollar eventually net out? "We've talked about that," says Terry Gray, Honeywell's director of global capital structure. "But we've never had a CFO or chairman that had a 20-year tenure."

Perhaps the best solution to fluctuating currencies is to create "natural hedges," in which revenues and costs are in the same currencies. Companies with natural hedges still have to translate foreign sales, profits, and assets into dollars at unfavorable rates for accounting purposes. But by using locally earned revenues to fund the production of local goods, for example, they reduce the hit to earnings that comes from exporting products from a strong-currency country to one with a weak currency.

IBM, for instance, locates facilities in countries where it does lots of business. Coca-Cola, rather than repatriating profits in devalued foreign currencies, reinvests in local bottling operations. Even Merck's Lewent says her company prefers natural hedges where possible. Derivatives such as currency options, she says, are a fallback because they need foreign revenues to cover U.S. costs, especially R&D. 3M executives may be more extreme than most in their distaste for hedging, but they're hardly alone.

Four Companies, Four Strategies

Does hedging protect against currency volatility? The record is mixed.

COCA-COLA A big hedger, Coke says that over the long term it can limit profit damage from exchange rates to 3% annually. But this year, analysts expect currency mismatches to erase about 10% of earnings.

EASTMAN KODAK CEO George Fisher ended aggressive hedging in late 1993, concluding that the benefits didn't justify the costs. Now, Kodak hedges only a few specific contracts, not its overall receipts and payments.

IBM By locating plants in many countries where it does business so its costs are in the same currency as its revenues, IBM reduces the impact of currency swings without hedging.

3M Arguing that gains and losses will even out over time, 3M does not hedge foreign-exchange exposure. Over the past three years, however, that has cost the company $ 330 million in profit.

LANGUAGE: ENGLISH

LOAD-DATE: October 22, 1998