FX Risk Exposure & Hedging Strategy: EUR Receivable

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Date Created: October 24, 2025
Date Updated: October 24, 2025
Version: 1.0

Executive Summary

Our firm faces a €4,500,000 receivable in one year from a European customer. With EURUSD currently quoted at spot and a 1-year forward rate of 1.0875, the dollar value of our expected proceeds is exposed to EUR depreciation. This memo outlines why hedging this exposure is prudent, introduces three hedge families, and details the methodology for analyzing them. A spreadsheet-based model will evaluate unhedged vs. hedged scenarios using forward contracts, money market hedges, and options. Our goal is to recommend the optimal strategy balancing risk reduction, cost, and potential upside.

Background & Objectives

Our company is expecting a €4.5M payment in one year. At today's forward rate of 1.0875, this receivable is worth approximately $4.893M. However, if the euro weakens over the next 12 months, our USD proceeds could fall significantly. This FX risk directly impacts our revenues and budgeting accuracy. The objective is to quantify the risk and evaluate three main hedging approaches, forward contracts, money market hedging, and options, so we can protect our earnings while considering cost and flexibility.

Methods

Hedge Families & Pros/Cons:

- **Forward Contract:** Locks in 1.0875.
  Pros: Full protection, no upfront cost.
  Cons: No upside if EUR strengthens.
- **Money Market Hedge:** Uses borrowing/lending at current interest rates.
  Pros: Lock-in value using balance sheet; good for cash-rich firms.
  Cons: Requires actual cash transactions; complexity.
- **Options (Put on EUR):** Buy the right to sell EUR at a fixed rate.
  Pros: Downside protection with upside potential.
  Cons: Premium cost ($0.015 per EUR contract).

Technical Specification:

- Create an Excel model comparing USD outcomes under different EURUSD spot scenarios.
- Inputs: Spot rate, forward rate, interest rates (USD & EUR), option premiums.
- Outputs: Net USD receipts for each strategy.

Prompt Engineering:

> "Given a €4.5M receivable in 1 year, spot and forward rates, interest rates, and option premiums, build a spreadsheet that compares USD proceeds under: (1) unhedged, (2) forward contract, (3) money market hedge, and (4) EUR put option hedge. Include scenario analysis for varying EURUSD spot rates."

Limitations & Next Steps

Limitations:

Interest rates and option pricing may change; the model assumes no default risk.

Next Steps to be done by Britney:

- Build Excel model.
- Gather interest rate data.
- Run scenarios and recommend a hedge in Stage 3.

References

- Investopedia. (n.d.). *Foreign Exchange Hedging*.
- Hull, J. (2021). *Options, Futures, and Other Derivatives* (11th ed.).
- Yahoo Finance (for EURUSD spot & forward quotes).