Foreign Exchange Risk Management in SME IT sector companies in Pune

Author 1: Nikhil Lokhande

Author 2: Dr. D B Bharati

Financial Management

Savitribai Phule Pune University, Pune, India.

Abstract : This study has been undertaken to assess the use of foreign exchange risk management in the SME IT sector undertakings in India. India has been one of the major exporter of IT & ITES services. Cities like Pune, Mumbai, Bangalore and Hyderabad have been topmost in terms of the exports. We have seen many emerging IT sector undertakings starting very well in this domain and growing to their fullest potential in some time. The volatility in the currency markets plays an imperative role in the profitability of these undertakings. Hence we wanted to understand how this important risk has been ingrained into these companies and how are they able to manage this risk.

Introduction : Financial markets across the globe have been in turmoil with currencies displaying high degree of uncertain movements. The Indian currency has witnessed sharp depreciation and increased volatility during the recent past, driven by both global and domestic factors. The episode began Post 2008 financial crisis, the advanced economies slipped into recession and faced protracted slowdown in their growth. Sovereign Debt crisis of Euro Zone countries, which subsequently followed, also hampered world growth. After the historic downgrade of USA by S&P in August 2011 that triggered heightened risk aversion and a selloff of assets in emerging economies including India by the Foreign Institutional Investors (FIIs). Risk aversion was further heightened on escalating euro-zone concerns, falling global growth and recent apprehensions over the US Federal Reserve tapering its bond purchase programme. While authorities across the globe have taken actions to stabilize markets and support growth, India has grappled with unique domestic considerations.

Indian Economy

Historically, the Indian rupee, which was at par with the American currency at the time of our Independence in 1947, hit an all-time low of 74.49 to the dollar in October 2018 but has partly recovered since then. Major reasons for such a drastic fall include: l. Continued Global uncertainty, Continued global uncertainties have led to pressure on most currencies against the US Dollar. 2. Moderation in capital inflows. 3. Moderation in GDP growth and decline in prospects of the economy. 4. High inflation. 5. Wide fiscal deficit. Major positive steps being undertaken and recent stability, the long term outlook for the Indian economy remains positive due to strong domestic demand spurred by rising incomes and aspirations, a skilled workforce, significant household savings and a young demographic profile. In recent days the positive outlook has been clouded by growth concerns, impending elections, burgeoning current account deficit and pervasive infrastructure bottlenecks. It is in such a challenging environment that Indian corporates seek to continue with their normal business activities and generate superior returns. With exchange rates in a state of flux it is increasingly difficult for business entities to make optimal decisions without the benefit of hindsight. It is imperative that all business entities explicitly understand and measure currency risks associated with their business. In the Indian market a large number of derivative instruments are available for corporates to effective manage their currency risks. The derivative products chosen should be consistent with the corporates' business, financial operations, skill and sophistication, internal policies as well as risk appetite.

Though the RBI has imposed the responsibility for due diligence and appropriateness of a derivative contract on the banks, the end-user corporates do have a greater responsibility in this regard. Identification, measurement and management of risks should be an integral part of the corporate governance structure.

The study will make us understand about the actual exchange risk management practices vis-à-vis the theory that is available. It will help in identifying gaps and problems.

Foreign Exchange Volatility:

Financial YEAR	USD/INR HIGH	USD/INR LOW	RANGE
2018-19	74.49	64.85	9.64
2017-18	65.90	63.25	2.65
2016-17	68.87	64.79	4.07
2015-16	68.79	62.04	6.75
2014-15	63.89	58.33	5.56
2013-14	68.83	53.81	15.02
2012-13	57.15	50.72	6.43
2011-12	53.72	44.07	9.65
2010-11	47.69	44.11	3.58
2009-10	50.52	44.92	5.6

India’s IT & ITeS industry grew to US$ 181 billion in 2018-19. Exports from the industry increased to US$ 137 billion in FY19 while domestic revenues (including hardware) advanced to US$ 44 billion.

Foreign exchange (FX) is a risk factor that is often overlooked by small and medium-sized enterprises (SMEs) that wish to enter, grow, and succeed in the global market place. There is a spectrum of opinions regarding foreign exchange hedging. Some firms feel hedging techniques are speculative or do not fall in their area of expertise and hence do not venture into hedging practices. Other firms are unaware of being exposed to foreign exchange risks. There are a set of firms who only hedge some of their risks, while others are aware of the various risks they face, but are unaware of the methods to guard the firm against the risk. There is yet another set of companies who believe shareholder value cannot be increased by hedging the firm's foreign exchange risks as shareholders can themselves individually hedge themselves against the same using instruments like forward contracts available in the market or diversify such risks out by manipulating their portfolio. They need to understand that the volatile nature of the FX market poses a great risk of sudden and drastic FX rate movements, which may cause significantly damaging financial losses from otherwise profitable export sales. The primary objective of FX risk management is to minimize potential currency losses, not to make a profit from FX rate movements, which are unpredictable and frequent.

Thus this study focuses on awareness of Fx risk hedging tools among the Indian SME corporate and also to evaluate the various alternatives available to them for effectively hedging their short and long term Foreign exchange risk.

What is foreign exchange risk?

Foreign exchange risk is the risk that a business's financial performance or position will be affected by fluctuations in the exchange rates between currencies. The risk is most acute for businesses that deal in more than one currency (for example, they export to another country and the customer pays in its own currency). However, other businesses are indirectly exposed to foreign exchange risk if, for example, their business relies on imported products and services. Foreign exchange risk should be managed where fluctuations in exchange rates impact on the business's profitability. In a business where the core operations are other than financial services, the risk should be managed in such a way that the focus of the business is on providing the core goods or services without exposing the business to financial risks. Sources of foreign exchange risk.

Foreign exchange risk for a business can arise from a number of sources, including:

- where the business imports or exports
- where other costs, such as capital expenditure, are denominated in foreign currency
- where revenue from exports is received in foreign currency
- where other income, such as royalties, interest, dividends etc, is received in foreign currency
- where the business's loans are denominated (and therefore payable) in foreign currency
- where the business has offshore assets such as operations or subsidiaries that are valued in a foreign currency, or foreign currency deposits

Research Methodology :

The researcher will collect the data by using primary source and secondary source for the research study.

- ➢ Primary data will be collected through structured questionnaire & interviews with IT sector companies focusing on objective of the research.

The secondary data will be sourced from-

- ➢ RBI annual reports & bulletins.
- ➢ Statistical database published by RBI.

- News papers, Chamber of Commerce Journals & Periodicals.
- Annual reports of the banks/corporate/industry associations/consultants.

Source of Data of IT Sector Companies:

MCCIA – Mahratta Chamber of Commerce Industry & Agriculture Pune. Industrial Directory.8th edition. Published in 2012-13.

SEAP – Software Exporter Association of Pune (http://www.softexpune.org)

NASSCOM - The National Association of Software and Services Companies (http://www.nasscom.in)

STPI – Software Technology Parks of India-Maharashtra (http://www.mah.stpi.in)

Population and Sample : Going by the number of more than 800 IT companies we take them as 1000 to account for non-registered entities. Thus, the population of IT companies in Pune is 1000. At 95% confidence interval and 5% confidence level the sample size fora population of1000 works out to 278

Data Analysis Techniques: Since standard deviation of the population is not known a t-test would be employed to do the inferential analysis for testing the hypotheses. The mean of the samples agreement percentage would be compared against a hypothesized population mean of 50% (meaning agreement by chance). If the samples mean is significantly different from the hypothesized population mean (as would be judged from the p-value) the null hypotheses would be rejected in favour of the alternate.

Sr. No.	Parameter	Value(s)	Interpretation
1	Disagreement percentage for responses to questions pertaining to awareness	85%	As the disagreement percentage is significantly higher than 50%, it can be interpreted IT sector companies are not fully aware about the hedging tools for effective foreign exchange risk management.
2	Disagreement percentage for responses to the questions on use of variety of tools for hedging	71%	As the disagreement percentage is significantly higher than 50%, it can be interpreted that IT sector companies are using only limited tools for hedging. .
3	Disagreement percentage for responses to questions pertaining to effectiveness of hedging tools	71%	As the disagreement percentage is significantly higher than 50%, it can be interpreted that the foreign exchange risk management at the IT Companies is not effective.
4	Agreement percentage for responses to questions on impact on financial statements	87%	As the agreement percentage is significantly higher than 50%, it can be interpreted that the effect of foreign exchange risk management is reflected in the financials of the IT companies.

Scope & Limitations of Study

We are selecting SME IT sector companies where the export sales turnover would be upto INR 100 crores per annum. Though the SME IT companies agree that while appreciation of risk is fairly ingrained at the operating managers level there was scope for better appreciation of risk at the Management level. A stronger organizational risk culture and greater support from the management are perceived to be the major areas of improvement for better risk management.

Although companies today attach greater importance to risk management in financial decision making, the approach still leaves much to be desired. While the focus on risk management has increased since the global financial crisis of 2008, market views still dominate risk management decisions rather than the risk profile and the risk appetite of the organization. Volatility and uncertainty in the markets during the last five years has brought about a greater focus on market risk by the top management. While there is no disagreement with the fact that companies need to manage Foreign exchange risk, the approach to be adopted differs from sector to sector and is often influenced by policies being followed by the peer group.

The dilemma of how much to hedge and for what tenor confronts most SME's and the crux of the dilemma is that companies do not want to lose out to competition in future because their portfolios are aggressively hedged nor do they want to miss out on the current opportunity of locking in profits on their exposures. This is particularly true of companies dealing with commodities and those in the IT/ITEs sectors.

Definition of MSME:

A.1. The Government of India has enacted the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006 in terms of which the definition of micro, small and medium enterprises is as under:

(a) Enterprises engaged in the manufacture or production, processing or preservation of goods as specified below:

(i) A micro enterprise is an enterprise where investment in plant and machinery does not exceed Rs. 25 lakh;

(ii) A small enterprise is an enterprise where the investment in plant and machinery is more than Rs. 25 lakh but does not exceed Rs. 5 crore; and

(iii) A medium enterprise is an enterprise where the investment in plant and machinery is more than Rs.5 crore but does not exceed Rs.10 crore.

In case of the above enterprises, investment in plant and machinery is the original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification No.S.O.1722 (E) dated October 5, 2006.

(b) **Enterprises engaged in providing or rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and other items not directly related to the service rendered or as may be notified under the MSMED Act, 2006 are specified below.**

(i) A micro enterprise is an enterprise where the investment in equipment does not exceed Rs. 10 lakh;

(ii) A small enterprise is an enterprise where the investment in equipment is more than Rs.10 lakh but does not exceed Rs. 2 crore; and

(iii) A medium enterprise is an enterprise where the investment in equipment is more than Rs. 2 crore but does not exceed Rs. 5 crore

Significance of Study

There are a variety of risks faced by a corporate in the course of its business. Some are internal and some external. Additionally, the corporate is actually in the business of taking some risks that it may be more competent to manage i.e. business risks, strategic risks, operational risks etc. The process of risk management starts with understanding the interplay between these various risks and accepting the fact that risks are not really eliminated but just transformed from one form to another using certain hedge instruments. Typically a corporate is competing with many peers (both domestic and international) in its line of business. Any FX hedges taken by it have to start with a projection of its expected FX exposures into the future. These projections are based upon certain assumptions about the state of its business performance in future. A decision taken by the corporate to hedge all of its FX exposures for the foreseeable future (say next 2 years) could leave it in an under/over hedged position depending on how its business actually performs v/s the projections. This under/over hedging could itself pose risks to the corporate. In other words, managing the FX risks, has actually transformed the risks into a business risk. Most companies so far have been approaching FX risk management as a view based approach i.e. take hedges when their view on market indicates that the market could move against their underlying exposure. This strategy may work in a stable market environment but in an event driven market environment, is likely to be quite un-predictable and hence risky. Hence, for most companies it would be prudent to follow a more scientific and systematic approach the key to achieve right hedging strategy is a function of available tools and its judicious mix. There is no single product that can take care of all Fx hedging needs. While generally, foreign exchange forwards and options have been considered to be good instruments for hedging short term trade exposures (exports and imports) and cross currency swaps for hedging longer duration loan exposures, we have seen this change with times. In current times of volatile currency movements, use of Fx (forex) options is clearly a desirable solution. Buying options is like buying insurance cover to protect your business from Fx risks. Hence any prudent Fx risk management solution should look at embedding some amount of insurance i.e use of bought option (be it vanilla bought options or bought option spreads). By paying a premium that is known up-front, the corporate can price it into their respective business models and protect it from future uncertainties. While nobody wants to be brave enough to call the top in the US dollar nor would one like to hazard a guess here while working on a risk containment strategy. Hence for an exporter, instead of locking in a particular rate through a forward contract, a mix of forward and bought options would be a more prudent strategy. And we have seen immense benefits of this strategy in the last couple of years. We are also seeing corporate clients, taking advantage of the listed currency futures and options on the local exchanges. However, given the low position limits and lack of liquidity on longer tenor contracts clearly exchanges cannot entirely fulfill, but definitely supplement, the hedging needs of the corporate. Using a combination of available tools in a disciplined approach to hedge all the identified FX exposures can place the corporate treasury in good stead.

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