Hedgewiz

Financial Risk Management

FASHION INDUSTRY: CURRENCY RISKS AND OPPORTUNITIES

The fashion industry is one of the most globalized industries in the world. It depends on sourcing materials from different countries and sells to customers across the world. Design, manufacture and retail sale of fashion products may involve different currencies.

Currency volatility risk is therefore one of the issues constantly on the table for industry players, whether they are small retail distributors or owners of large international luxury brands. This risk becomes even more prominent during periods of sharp currency movements that can significantly impact seasonal profitability or even brand profitability in certain countries. 2018 is one such period, with the first half seeing 8% appreciation in the USD, 60% depreciation of the Turkish Lira and over 7% appreciation in Renminbi against EUR.

This paper discusses the main currency Risk issues raised by the industry's CFO's and offers solutions to deal with them. The effectiveness of using hedging instruments is discussed as a way to manage risk but also in the context of lost flexibility that may potentially affect profitability in a highly competitive industry.

Choosing the currency for contracts with foreign suppliers

A majority of European and US brands and retailers either have manufacturing activity abroad or heavily depend on purchases from foreign suppliers, mainly in Asia. This creates recurring foreign currency payments, usually in USD or Euros to avoid exchange rate losses due to sharp local currency volatility and limitations and costs related to local currency transfers. However, this practice may result in less favourable pricing and in some cases, even cause suppliers to resist signing long-term contracts.

However, when there is an opportunity to negotiate prices in local currencies, it may be worth considering. Obviously, such decisions should be based on the company's ability to hedge the risk of local currency volatility (e.g. the availability of hedging instruments and hedging costs).
Some currencies can be hedged on a "Non-Deliverable" basis, meaning that the transaction can be priced in local currency and still paid in USD. In such cases, hedging instruments cover the volatility gaps.

The table below provides information about availability and hedging cost of several currencies that are relevant to the fashion industry. The data pertains to August 2018.

Currency	Hedging tools	Hedging cost / profit (vs EUR) for 12 months (forward points data)
Turkish Lyra	Available	30% (profit if buying Lira)
Indian Rupee	Available	7.9% (profit if buying Rupee)
Vietnamese Dong	Not Available	
Chinese Renminbi	CNY - non deliverable forward contracts are available. Deliverable contracts usually available for Sell CNY only. Possible to hedge CNH	4% (profit if buying Renminbi)

Benefiting from globalization and extended global reach

The fashion industry is becoming more and more globalized, not just on the suppliers' side but also customers' side. Many brands are going global because of e-commerce infrastructure which allows customers and sellers from different countries to transact. Some companies choose to price goods in in local currencies (a dedicated pricing list), which immediately exposes them to currency volatility till the actual payment. Others price in their currency but allow immediate conversion to local currencies (live rate conversion). This shortens the risk period from the sale till the receipt of the payment by the merchant. In both cases the exposure exists even if the payment is received by the merchant in his home currency.

Regardless of distribution channel, it is important to mention that the pricing mechanism is usually "collection based" and the company has the ability to update prices at the time of the new collection release, reflecting currency movements. The company should build this into its hedging strategy by choosing the relevant hedging period.

Covering time to market

Today's market and production opportunities create a significant gap between the "Traditional" and "Quick" fashion retailer in terms of time to market. For the "Traditional" players, time from planning and pricing the collection to actual sale can be over a year. They usually have very limited ability to update prices or change collections if the exchange rate moves adversely. On the other hand, their "Quick" fashion competitors go live with their products much faster. This reduces their exposure and offers greater flexibility in pricing. The duration of exposure affects the hedging needs of both types of retailers. While the use of long-term hedging instruments can protect profitability of the "Traditional" player it can also hurt its competitiveness vs its more flexible competitors.

The takeaways

Fashion companies are exposed to the impact of currency fluctuations from both supply chains and consumers. Different options are available to deal with this challenge. These include price adjustments, altering sourcing locations, changing retail locations and hedging in the foreign exchange markets to increase certainty, and protect profitability at least in the short term. It is therefore important for companies in the fashion industry to be familiar with different hedging options available and their costs based on where their suppliers are located. It is also important to analyse different aspects of currency risk, given the markets the company seeks to address, the pricing strategy and overall business strategy. This will ensure that the chosen exchange rate risk strategy fits the overall risk appetite well.