HEDGING; A FOREIGN INVESTOR'S HAVEN IN CURRENCY VOLATILITY CRISIS

Foreign exchange ("forex") is generally one of the most volatile assets in any economy. Given the combined effect of Nigeria's import-based economy, and its currently depleting forex reserves, the Nigerian forex market has in recent times experienced a rapid price hike and has in turn, led to a stagflation with no end in sight. Interestingly, this situation is not peculiar to Nigeria alone. The currencies of most emerging economies appear to have slumped against the US Dollar.

A real life scenario of excess volatility occurred when the USD was being sold at 300 Naira to 1 USD in January of 2016 and rose all the way to a record-high of 495 Naira to 1 USD, a few months thereafter. It is not news that the simple economic factors of demand and supply are responsible for this occurrence, resulting in general increase in cost of doing business in the country.

Incidentally, the Federal government is at this time, welcoming foreign investment in various sectors of the Nigerian economy. No doubt, Nigeria is naturally endowed with many resources that are largely under-tapped, and an existing market for almost every product or service! But in spite of the availability of these luscious resources amongst other factors, there are very pertinent questions to which every potential investor requires an answer; How do I obtain forex at a minimum cost, for the purpose of fulfilling my external obligations? Can access to forex be guaranteed at the same value at which I imported it? We may recall that many had clamoured for the official peg on the foreign exchange price to be lifted by the Central Bank of Nigeria due to the belief that it was disrupting the flow of foreign investment into Nigeria. The general consensus was- "let us allow the forces of demand and supply determine the market price." But even after a flexible exchange rate policy had been put in place, foreign investment remains stagnant for the simple reason that the root cause of the dollar crisis has not been addressed. Dearth of the US Dollar has continued to cripple the economy thereby placing a strain on the parallel market, where the price continues to rise and then the margin between the inter-bank market, (which is often the source of importation) and the parallel market (often the source of repatriation) rate continues to widen.

This is not an attempt to declare a miracle-working solution to this current fiscal menace. Nonetheless, unlike natural disasters which are beyond human control, financial crisis are man-made and must have man-made solutions. As far as my trade is concerned, ***hedging*** is a practical means by which investors can curb the effect of foreign exchange volatility on their business. Many investors who are already doing business in Nigeria are constantly in search of means of cutting their losses. Potential investors are seeking the same answers.

At present, it is also true that the same menace obstructing the influx of foreign investment, is also impeding investment by hedge funds in foreign currency for obvious reasons; the risk of investment is too high and no hedge counterparty is willing to bear a potentially huge loss. But there are other creative and less institutionalized means by which investors can hedge and these are discussed below;

Natural Hedge

This is probably the most common and least complex hedging tool available to businesses. A natural hedge occurs where one investor ensures that its income is priced in the same currency as its expenditure. Therefore, the investor's income is not susceptible to exchange rate fluctuations, since the requirement for purchasing forex is eliminated. In this instance, the investor will need to ensure compliance with regulation which may restrict pricing of certain transactions in foreign currencies.

Currency Swap

A currency swap involves contractual arrangements between parties wherein they agree to exchange one currency for another. Essentially, a party swaps a currency it does not need with a party who needs that currency for the required currency by transferring its interests and liabilities in one currency for another at a pre-determined exchange rate, without exposure to any future fluctuations in the market

FX Options

An FX option is similar to an insurance policy in the sense that the purchaser of the policy pays a premium for it. In this case, the buyer has the right to purchase foreign exchange from the seller at a future date and at a pre-agreed exchange rate upon the occurrence of certain identified events.

Forward Contracts

Forward contracts are used by parties to sell or purchase foreign currency at a future time but at a pre-agreed price and exchange rate irrespective of future market prices.

These simple hedging tools can aid investors in cutting their losses in an unending forex repatriation crisis. Again, these identified tools are by no means exhaustive and are not intended to create any economic certainties. But they are practical solutions which can be tailored to the needs of each investor and have been effective when applied efficiently, taking into consideration factors such as cash-flow, cash reinvestment, business transparency and compliance with law and regulation.

This newsletter was written by **Aderonke-Alex Adedipe**
Partner
Strachan Partners
5th Floor 24 Campbell Street
Lagos Island,
Lagos

Please note that this alert is for general information only. It is not offered as advice, on any particular matter, whether legal, procedural or otherwise.