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Is FX material to your business?

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Key takeaways

If you have operations, clinical trials or have commercialized outside of the US, foreign exchange (FX) can impact your results; the impact may be material.

You can use the factors described in this article to help identify and quantify materiality.

Assessment of materiality for fast growing innovation sector companies is not a one-time exercise, but an integral part of the financial planning & analysis (FP&A) process.

Unexpected FX costs can be a headwind

Most companies look at FX costs, as they arise, as a standard business expense. Currency is bought as needed and repatriated as soon as it's earned. This type of unexamined currency exchange operation may create unexpected losses, increasing over time.

There are many ways to help manage these risks, so there's no need to accept FX risk as a cost of doing business internationally.

You can identify and quantify FX risks

This article provides guidance on how to determine the materiality of the FX risk you inherited by deciding to operate globally.

Simply by examining the FX risk, which can mean embedding FX rates into your FP&A process for instance, you have moved beyond passively accepting it – you are actively managing FX risk. That's good. See our recent FX Risk Advisory article for a deep dive on this concept[1].

What is materiality?

Materiality is a function of two factors, size and potential impact. The combination of these factors constitutes a company's currency exposure.

Size corresponds to the amount of currency that must be transacted over a period of time, or the value of assets and liabilities denominated in foreign currencies, or some combination of the two. Impact measures the potential loss that would arise from an adverse move in the foreign currency. This projection can be based on historical patterns, or currency option prices, and is generally associated with a level of probability.

FX exposure is specific to your operating model

Some examples:

Suppose a global commercialized life science company receives a quarter of its revenues in Hong Kong dollars. The size of the FX exposure is large relative to the total; however, the Hong Kong dollar is a currency that is pegged to the USD (and so does not move vs. the USD) and it has been so for close to four decades. The likelihood that this peg breaks over a fiscal year is remote. Thus, size combined with the potential impact of the currency move would not trigger the materiality threshold.

In contrast, a pre-commercialization life science company that raised in USD but incurs expenses in China will find the value of the renminbi (RMB) versus the USD exhibits noticeable swings from one period to the next; the longer the period, the larger the swings. Since the peg to the USD was lifted in 2005, the RMB has appreciated close to 10% on three different occasions[2]. Taken together, any size of annual renminbi spend can translate into a material currency exposure for a growing firm, especially if there are no RMB revenues to offset the liabilities.

Where will you need to look to assess FX materiality for your company?

[1] FX Risk Advisory for LSHC: Active vs. Passive FX Management May 2021

[2] Bloomberg April 2021

A checklist of factors that create FX materiality

For life science and healthcare corporations:

- What proportion of operating expenses are denominated in currencies other than the dollar? What is the mix of currencies?
- To what extent will a rise in foreign currencies adversely impact your cash burn and runway?
- Where are your customers/vendors? Do you have the ability to price in USD for your customers/vendors outside the US? How sustainable is this arrangement?
- If you cannot price goods or services exclusively in USD, what percent of revenues are denominated in foreign currencies?
- Do you need a foreign entity to operate outside the US? If you are billing and collecting overseas directly for the parent through a third-party payment provider who is doing the conversion to USD for you, are there hidden FX risks to consider?
- Do you anticipate raising additional capital that is earmarked for expenses in a different currency?
- What is your overseas profit repatriation strategy?

Note: there may be other factors that impact FX materiality

Any of these factors may indicate that your business has potential exposure to FX risk. To help prevent or mitigate the unexpected costs of unpredictable currency exchange rate fluctuations, the exposures need to be actively tracked, measured and examined and, if warranted, actively mitigated.

FX risk mitigation will take different forms in different companies, as the examples suggest. Choosing the right approach requires that you know the source of the exposure.

One method of determining FX materiality is to look backward. For example, for your existing European clinical trial, examine your budgeted foreign expenses against actual revenues/expenses. Was the difference material? If so, you should not rely on passive FX management, but should start using active FX management strategies to prevent unwanted expenses in the future.

Ideally, the backward looking exercise described should be done in conjunction with a forward looking analysis which involves incorporating FX budget rates into the FP&A process. Statistical techniques can be utilized to project a range of outcomes for the business, net of FX, providing an objective framework that can be used to make informed decisions about whether or not to proceed with hedging and to what extent.

A benchmark for materiality

There are guidelines for levels of materiality that call for risk mitigation.

Generally speaking, a useful rule-of-thumb for some companies is if a minimum of 20 percent of top-line revenues, operating expenses (OpEx), or earnings (EBIT) is projected to be realized in foreign currencies, then the “size” threshold is met and it is time to pay attention to FX. SVB can work with you to help gauge whether size coupled with potential impact means your company’s exposure is material.

For material exposures, active management of currency risk makes sense. For more information about active and passive FX management, read our recent FX Risk Advisory: Why passive FX management falls short.

Let us help you:

- SVB stands ready to help assist clients better understand and, if appropriate, manage their currency exposure and identified risk.
- SVB has a dedicated team and a robust suite of global payments and foreign exchange solutions to help LSHC clients better deal with their unique challenges.
- Your success is our goal. Contact your SVB FX Advisor, Peter Compton, Head of FX Life Sciences & Healthcare Practice at pcompton@svb.com, or Ivan Oscar Asensio, Ph.D., Head of FX Risk Advisory at iasensio@svb.com.

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