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To Hedge or Not to Hedge

When does it make sense, and what are the alternatives?

by Kapil Sharma & Mark Working

Earlier this year, Derek Kerr, the CFO of American Airlines, explained why he does not hedge fuel costs.[1] At American, fuel represents 20-25% of total costs, second only to payroll. Is Kerr being reckless? Why don't carriers like Alaska and Southwest share his views on fuel hedging? In this article, we will discuss

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why companies hedge, when it makes the most sense, and what are some alternatives to hedging for managing business volatility.

WHY HEDGE?

Volatility in global commodity and currency markets has been a condition since the beginning of trading and mercantilism. For some perspective, the Dojima Rice Exchange in Japan was the first to trade standardized futures in 1730, with two types of rice markets. In modern times, executives with exposure to underlying input price volatility have a wide range of market options and tools to hedge such exposure. The purpose of hedging is always the same – to reduce uncertainty.

Let's go back to American Airlines to understand the cost of hedging. According to Kerr, with oil at $60 a barrel today, the cost to lock-in a cap on prices at $70 for a defined future period would be roughly $10. So, American wouldn't be better off for buying the hedge unless the price of oil during the hedge period averages $80 or more. Kerr's position is that the cost of fuel hedging is currently too high.

Whether American buys or doesn't buy the hedge, by the mere fact that it consumes commodities that have volatile market prices, it is making a commodities bet.

Hedges are not costless, and hedging can't help a business escape the realities of risk-return tradeoffs related to the markets in which it operates. Reduced volatility in the short-term means lower profits for the purpose of avoiding potentially even lower profits. As such, hedging, for the most part, is a technique not by which money is made, but by which potential losses are reduced.

ESTIMATING TRUE FINANCIAL EXPOSURE

With the objective of entering into a commodities hedge to dampen the volatility of profits, sometimes it's easy to get caught up in the perfection of the hedge without recognizing that the hedge may not be directly connected to the company's profits.

The first issue is the imperfection of the hedge itself. Hedging an index of commodity prices (world oil prices in our example) may not link directly to the cost of a specific input for a given business. Unless the specific input is contracted for at known volumes, there will always be some imprecision to the hedge.

The greater issue is how the business is able to reprice its products or services as its inputs

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change. Consider oil refineries where crude oil costs are the majority of total costs and where they are able to rapidly pass on most crude price changes to their customers. A perfect hedge in this case may actually increase volatility as it locks in a fixed cost to a variable revenue stream.

WHEN DOES HEDGING MAKE SENSE?

A business can't avoid all risks, particularly those specific to its industry. Businesses make profits by consistently pricing their services and/or products at levels that compensate for these risks.

Hedges are most appropriate when a business is in a situation so precarious that it can't afford the downside potential of market movements, or when assets and liabilities are mismatched. Examples of appropriate hedges in both cases include:

- A low-margin manufacturer or distributor with customer prices set for an extended period. In that instance, hedging input costs

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(perhaps through futures or purchase commitments) for the same period makes sense as the business may not be able to survive sustained volatility; or

- A business with a stable margin profile (as a result of stable prices and known costs) with high leverage enters into an interest rate swap to protect against interest rate swings that could erase its profit margin. The capital structure is agnostic to the market dynamics of the business and therefore protecting business value from unrelated market swings until leverage is reduced is a worthy goal.

ALTERNATIVES TO FORMAL HEDGING TOOLS

Besides hedging, businesses can take other actions to address profit volatility and commodity risks. Examples include:

- Holding greater cash reserves to fund the down cycle.
- Shutting plants when input costs become unsustainable.
- Vertical integration. Going back to our airline example, in 2012 Delta Airlines made a controversial move to acquire an idled oil refin-

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ery in Trainer, Pennsylvania.

- Passing on currency risk to suppliers and/or customers by contracting only in U.S. dollars. This is a complicated issue as the underlying risks may not go away and to think that assigning risk to a supplier or customer will have no impact on your revenue or cost stream might be perilous.

Any business operating in a market where certain costs or revenues are subject to market movements, not directly controlled by the business, can't escape the volatility it implies. Given enough time, a business in that market will suffer during some periods and gain windfalls during others.

Entering into hedges reduces overall long-term profits. But, as Maynard Keynes famously quoted, "In the long run, we're all dead." Choosing how and when to use hedging tools largely depends on a company's specific situation, the company's ability to weather cycles, and the owner's risk appetite. Since no one can reliably predict commodity, currency, or interest rate movements, the impact of any particular hedge is likely to be random. The only given is the collective costs of all hedges. Over time, in exchange for reducing business volatility, these costs will also reduce profits. **ZS**

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