Foreign Exchange Exposure Hedging: A Case of TCS

Backdrop:

Foreign currency fluctuations are one of the key sources of risk for all the firms – be it multinational or pure domestic firms. The changes in the exchange rates would have an impact on the firms' cash flows, valuation, demand and supply dynamics. The volatility in the exchange rates bother both the long term capital flows (Foreign Direct Investments) and the short term capital flows (Portfolio and Foreign Institutional Investors).

Tata Consultancy Services (TCS):

TCS is a leading global IT services, consulting and business solutions company. It leads the Indian IT pack. A part of the Tata group, India's largest multinational business group, TCS has over 448,000 of the world's best-trained consultants in 46 countries. The company generated consolidated revenues of US $22 billion in the fiscal year ended March 31, 2020. In FY 2020, TCS's revenue registered a revenue growth of 7.2% over the prior year in reported terms, and 7.1% in constant currency terms.

TCS's geographic footprint covers North America, Latin America, the United Kingdom, Continental Europe, Asia-Pacific, India, and Middle-East and Africa. TCS considers industry verticals as its go-to-market business segments. The five key vertical clusters are: Banking, Financial Services & Insurance (BFSI), Retail and Consumer Business, Communications, Media and Technology (CMT), Manufacturing and Others. The last category includes Life Sciences and Healthcare, Energy, Resources and Utilities, Public Services and others.

Forex Exposure:

TCS mainly deals with USD, GBP and EUR. The revenue composition is provided below.

Currency Exposure and Average Exchange Rates during FY 2020

Currency	Weightage (%)	FY 2020 (INR)	FY 2019 (INR)	% Change YOY
USD	53	71.23	70.07	1.7
GBP	14	90.15	91.6	-1.6
EUR	10.7	78.94	80.82	-2.3

Source: TCS Annual Report 2019-20

It also deals with other currencies like SEK, SGD, AUD, CAD, ZAR and QAR. TCS's functional currency is the Indian Rupee. Appreciation of the Rupee against any major currency could impact the reported revenue in Rupee terms, the profitability and also result in collection losses.

Hedging Policy:

TCS follows a currency hedging policy that is aligned with market best practices, to limit impact of exchange volatility on receivables, forecasted revenue and other current assets and liabilities. Hedging strategies are decided and monitored periodically by the Risk Management Committee of the Board convened on a regular basis (TCS Annual Report 2019-20). The Group designates certain foreign exchange forward, currency options and futures contracts as hedge instruments in hedges are accounted for as cash flow hedges.

Significance of Technology:

Data science and big data analytics are handy for devising the forex hedging strategies. Tata Consultancy Services' BaNCS Network Promises to Revolutionalize Cross-Border Flows with Real-time Settlements that Reduce Currency Risks and Enhance Liquidity.

Roles:

In developing the currency hedging strategies and to understand the ecosystem of the forex management, the following roles are critical.

Forex Market: Exchange and Over the Counter (OTC) Platform
Risk Manager: Risk Assessment and Mitigation Strategy
Derivatives Expert: Weighing the relative efficacy of Futures, Options, Swaps and Forward
Internal Hedging Expert: Denominating in home currency, natural hedging etc.
Data Scientist: Leveraging on Analytics to study the volatility of exchange rates
Authorised Dealer/Banker: Two way quotes and broken date contract quotes
CFO: Overall in charge of forex hedging

Required / Prompts:

(a) Analyse the TCS' position as far as forex exposure.

(b) Elaborate each role and prepare a dashboard for decision making.

(c) Develop a plausible forex hedging model for TCS.

Pre-reading Material:

TCS Annual Report 2019-20

Target:

Students of Finance Specialisation, 3rd Semester