svb Silicon Valley Bank
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FX can help with your bottom line

FX management can help improve financial results for technology companies.

- We present evidence of stock price outperformance for small-capitalization technology companies growing earnings faster than revenues.
- Active management of currencies is an important lever to pull for companies with a renewed focus on earnings.
- Balance-sheet hedging programs aim at protecting current period earnings, while cash flow programs insulate future earnings.

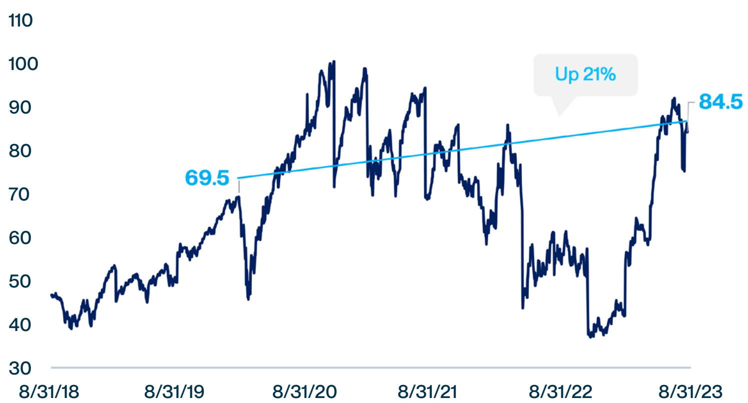
US tech investors increasingly value earnings over sales growth.

The focus on corporate profitability instead of 'growth-at-all costs' has gained wide acceptance in the innovation economy. Venture funds have proactively delivered this guidance to their portfolio companies and are now reinforcing it with their investment dollars. Finance functions have responded by implementing strategies to rein in costs and achieve operational efficiencies. And most recently, valuations are starting to favor firms that demonstrate improvement to the bottom-line over just growing sales.

As illustrated in Chart 1, the price-to-earnings (P/E) ratio of the Dow Jones US Small-Capitalization Technology index (Bloomberg ticker: DJUSSTH)[1] is currently 21% above pre-pandemic highs at 84.5, a sign that investors are willing to pay a higher premium to own a stake in a company's future projected earnings, and earnings growth. In contrast, Chart 2 shows that the price-to-sales (P/S) ratio of the index has been flat at 2.5 over the same time period.

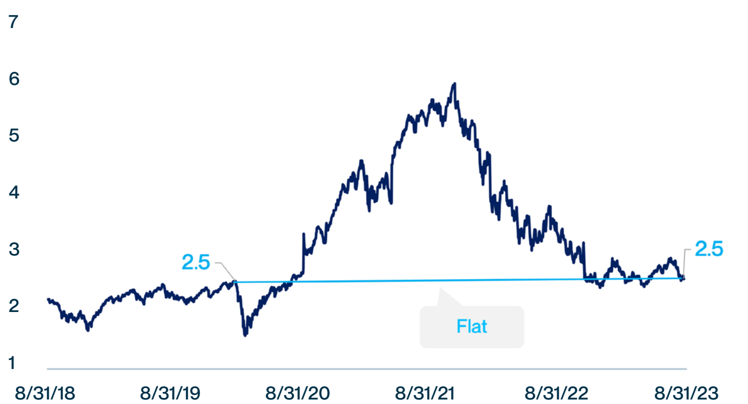
The divergence between P/E and P/S ratios over a period in which the DJUSSTH Index appreciated 29%[2] gives rise to two important insights. First it implies that earnings have been a more important driver of stock prices. And two, organic top-line growth has not translated to higher valuation multiples for this segment of stock market, a clear departure from previous sentiments.

Chart 1: DJUSSTH Index price-to-earnings ratio



Source: Bloomberg

Chart 2: DJUSSTH Index price-to-sales ratio



Source: Bloomberg

1 This index, comprised of 77 publicly traded companies, is designed to track the US small-cap technology segment of the market.

2 The DJUSSTH index appreciated 29% between 02.20.2020 and 08.25.2023.

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Better performing companies are growing earnings faster than revenues.

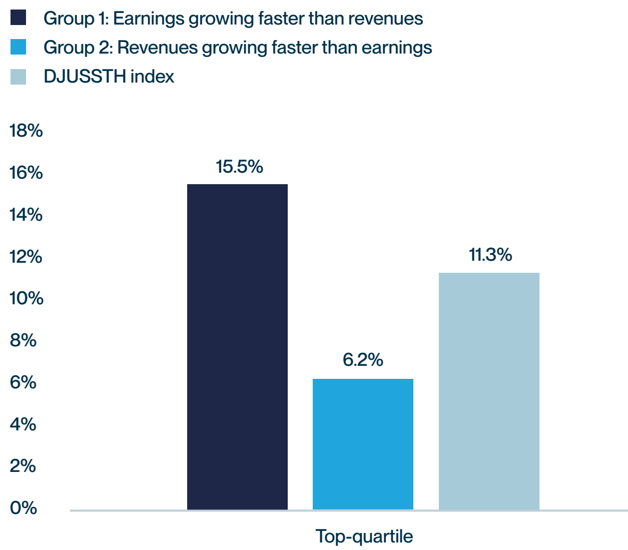
Digging deeper into the dataset, there is roughly a 50-50 split between firms registering faster quarterly earnings growth versus quarterly revenue growth, according to the latest public filings[3]. Sorting each group by stock performance over the last quarter, we find that the top-quartile of Group 1, firms growing earnings faster than revenues, outperformed the top-quartile of Group 2 as well as the general index. Also notable, the top-quartile of Group 2 underperformed the index.

Given the increased scrutiny on delivering earnings, corporate finance functions typically deploy cost-control strategies involving the management of cash, liquidity, investments, and foreign exchange (FX). Related to the latter, one important lever to pull is FX hedging. For example, earlier-stage technology companies, such as those in the DJUSSTH Index, generally fund foreign operations with US dollars (USD), as foreign revenue bases may yet be fully established. FX forward contracts are typically used to hedge non-USD expenses, aligning actual spend with fiscal year budgets and projected earnings.

We observe the importance of FX hedging in this context by finding that within the pool of companies growing earnings faster than revenues, those that hedge currency risk further outperformed, according to the top-quartiles illustrated in Chart 4. While not an attempt to establish causation, we conclude that **currency hedging is a feature present in companies focused on and being rewarded for earnings growth.**

There are two widely used approaches for insulating earnings from unwanted FX volatility. The first, known as balance-sheet hedging, aims at protecting current period earnings from remeasurement of existing assets and liabilities. The second approach targets future earnings by hedging anticipated FP&A cash flows. Public companies tend to prioritize the former, while private companies the latter. However, the two types of hedge programs are not mutually exclusive, in fact, it is not uncommon for maturing companies to have both programs running in tandem.

Chart 3: Equity performance since Q2 2023 start



Source: Bloomberg

Chart 4: Equity performance since Q2 2023 start

Source: Bloomberg

If you'd like to discuss your specific situation or for information regarding SVB's tailored FX risk management services, reach out to your SVB FX contact or **GroupFXRiskAdvisory@svb.com**

3 Latest filings as of 08.17.2023. Earnings growth is quarter-over-quarter change in trailing 12-month EBITDA. Revenue growth is quarter-over-quarter change in trailing 12-month top line revenues. Source of data: Bloomberg.

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