Silicon Valley Bank

Executive Summary

Why high-growth firms should pay attention to currency

Data insights by Silicon Valley Bank indicate that addressing currency risk may help support profitability at high-growth technology firms.

For years, investors in early-stage technology companies rewarded top-line growth above all else. The environment changed abruptly in 2019, highlighted by the contrast between IPO successes at profitable firms like Zoom and the challenges faced by a number of unprofitable technology companies. This climate heightens the need for emerging firms to focus on the bottom line. That emphasis includes understanding, quantifying and managing the full range of risks to earnings. Foreign exchange (FX) represents one key risk.

To gain insight into the currency exposures and practices of high-growth venture-backed tech companies, Silicon Valley Bank (SVB) analyzed data from tech companies' filings for US initial public offerings between 2016 and 2019. These filings include information about actions the firms had taken during the previous 18 to 24 months, offering a snapshot of the currency-related practices of private, high-growth companies during venture rounds of funding.

The SVB study identified considerable currency risks for these firms. Technology companies that went public during the four-year period under review listed substantial revenues outside of the United States at the time of filing and overwhelmingly recognized FX as a key risk factor. Yet relatively few companies actively managed currency risk by using derivatives.[1] In fact, S-1 filings suggest that firms preparing for IPOs had much less visibility into the materiality of their FX risk than they should have based their size and global footprints.

Follow-up research examined post-IPO companies. We found that, as a group, small-cap public US tech companies that hedged FX risk with derivatives performed better on key profitability metrics than those that did not. Young, private technology firms may want to emulate the FX practices of their most successful post-IPO brethren.

High-growth firms had surprisingly large FX exposures

Our research found that at the time of filing:

9 in 10 companies reported global revenues

One-third of filing companies' total revenues originated outside of the United States

Revenues were growing **50% faster** outside the US than within the US

9 in 10 companies cited FX as a "key risk factor"

The proportion of sales outside of the US approaches that of S&P 500 firms, which on average generate approximately 42% of revenues outside the US[2]

Nevertheless, companies have low visibility into their currency risk and few use hedging strategies to manage it.

1 in 10 companies use derivatives to hedge FX risk

Among companies that have foreign-denominated revenues, **1 in 6** companies hedge with derivatives

Most companies do not explicitly disclose the impact of FX on their income statements

Why FX matters

We wanted a way to determine whether actively addressing currency exposures translates to better business performance and/or greater shareholder value. To that end we examined comparable companies that had reached the next stage of the business lifecycle: publicly traded small-cap US technology firms, represented by the Dow Jones US Small-Capitalization Technology index (Bloomberg ticker: DJUSSTH). We sought to gauge whether currency hedging at these firms was associated with improvements in profitability.

Our study placed the 79 firms in that index into two buckets: one for companies that used derivatives to hedge currency risk and one for those that did not. We found that the companies in the index were far more likely to use derivatives to hedge currency risk than their pre-IPO counterparts — four times as likely, based on pre-IPO firms' S-1 filings. Moreover, our analysis found that, as a group, small-capitalization tech companies that hedged currency risk using derivatives had higher EBITDA, smoother EBITDA growth, wider EBITDA margins and a lower incidence of negative earnings than those that did not, after controlling for company size.

As young, private companies build toward and beyond their IPOs, they may want to consider incorporating the best practices of successful firms that have come before them — and in this climate, they may want to place particular emphasis on practices associated with profitability. The evidence indicates that more-profitable small public companies are more likely to be conscious of their FX exposure and intentional about managing it. High-growth and pre-IPO firms might weigh these more profitable firms' example as they look to strengthen their bottom line and attract investors.

What companies can do

We recommend that both pre- and recent-IPO technology companies take steps to:

Improve visibility into the impact exchange rate fluctuations have on their results

Determine how material that impact is

Consider approaches appropriate for your company to **manage FX risk**

Review options that may include starting with "natural" approaches such as strategically holding foreign currencies and progressing to the use of derivatives where appropriate

This kind of thoughtful approach to managing currency risk may help young, innovative firms position for success, in both today's investment climate and tomorrow's global marketplace.

View full study

Talk to us: Please contact us if you'd like to discuss your specific situation or discuss the findings of this study. You can contact your SVB FX Advisor directly,or email the author of this study, Ivan Oscar Asensio, Head of FX Risk Advisory, at iasensio@svb.com.

[1] Derivatives in the context of this paper refer mainly to forward contracts which are the primary tool firms use to manage FX risk. An FX forward is a contractual obligation to exchange one currency for another at a pre-determined rate and date in the future.

[2] Standard & Poor's. https://us.spindices.com/indexology/djia-and-sp-500/sp-500-global-sales.

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