Better Practice Financial Risk Management - Governance and Strategy

DANE BIRDSEYE
GROUP TREASURER, COCHLEAR LTD

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FX Risk Management Strategy

DANE BIRDSEYE
GROUP TREASURER, COCHLEAR LTD
Corporate Overview

- Cochlear Limited (ASX:COH) is the global leader in implantable hearing devices
  - Cochlear implants
  - Bone conduction implants
  - Acoustic implants
- 3,000+ employees
- Direct operations in 20+ countries
- Products sold in 100+ countries
- Market cap - ~A$10bn (Top50 ASX)
Global footprint

- 450,000+ implant recipients
- 20+ countries with direct operations
- A$150m+ in annual R&D investments
- A$1.2b+ in annual sales revenue
- 3000+ employees around the world
- 4 key manufacturing sites
- 100+ collaborative research programs worldwide
Hearing loss market opportunity

360,000,000

Over 5% of the world’s population - 360 million people - has disabling hearing loss (328 million adults and 32 million children).¹

1 in 3

Nearly 1 out of every 3 people over the age of 65 are affected by hearing loss. It affects communication and can contribute to social isolation, anxiety, depression and cognitive decline.²

37,000,000

people who could benefit from a cochlear implant to treat severe to profound hearing loss.³,⁴

<5%

Market penetration.⁵
We innovate and bring to market a range of implantable hearing solutions that deliver a lifetime of hearing outcomes.

**Market-leading technology**
- Strengthen our technology leadership

**Clinical evidence**
- Expand research and trials to build clinical evidence

**Future focus**
- Hearing outcomes
- Lifestyle
- Connected care
Market leading product portfolio

Cochlear implants
- Nucleus® System
  - Nucleus® 7 behind-the-ear sound processor
  - Nucleus Series cochlear implant
  - Kanso™ off-the-ear sound processor

Acoustic implants
- Baha® System
  - Baha® 5 sound processor
  - Baha® 5 Power sound processor
  - Baha® Attract
  - Baha® 5 SuperPower sound processor
Types of FX Risk - Transaction

• 3 types - Transaction, Translation and Competitive/Economic

Transaction Exposure
• This is the exposure that arises when an organisation is either paying or receiving foreign currency and needs to convert it back to its functional currency.

• Can be related to OpEx, CapEx or Revenue.
Translation Exposure

1. Balance Sheet Revaluation - arises when a company has an asset or liability in a different currency and its value needs to be converted back to the functional currency for inclusion in the financial statements.

2. P/L Revaluation - relates to the actual conversion of foreign entities P/L into AUD. It is the risk that the revenue converted into AUD terms will be less than forecast at the time it was recognised, or that payments for foreign currency expenses converted to AUD will be more than budgeted for.
Types of FX Risk - Economic

Competitive / Economic Exposure

• arises when a competitor sources its goods from a different country, which may lower their costs enabling them to offer their product more cheaply; or

• sells goods in local currency rather than a major currency eg: USD or EUR

• It is the risk of worsening the competitive position of Cochlear due to mid and long term exchange rate movements.
Purpose & Objective of Hedging

Purpose

• The purpose of hedging foreign currency transaction risk is to smooth out the cashflows and P/L impact to create some certainty.

• This allows for better cashflow forecasting and in turn management of funding and liquidity risk.

• Hedging allows Treasury to achieve its objectives of managing financial risk within acceptable parameters and to ensure that sufficient funds are available to fund the company’s liabilities.

Objective

• There are 3 main objectives for hedging of FX risk, which also determines the timeframe over which the hedging occurs. These objectives are as follows.

  1. To protect the business at a known rate – protects the business within defined time horizon where it cannot react to the changing environment quickly through changing prices or shifting production. Hedging would typically occur over a medium term of 12 months+ and would be linked to the budget process and budget rate setting.

  2. To reduce Profit/Loss volatility – possible only over the medium term after which the long term changes in rates will be reflected in NPAT. Hedging typically 1 – 3 years forward on a rolling basis, with tiered hedge ratios.

  3. To reduce uncertainty of cashflow – focus is on predictability of short to medium term cashflow. It often implies a short hedging horizon such as for material committed exposures only or 3 – 6 months forward.
Hedging Approach

Approaches to achieve objectives are:

• Full Year hedging – If objective is to protect the business for the current budget period, hedging may take place during the budget setting process and therefore timing is critical. This hedge would only impact the relevant budget period.

• Rolling Hedge – implemented to protect the next 12 months position on a rolling basis, ie: hedging 12 months each month or quarter. This approach leads to a delay in the impact of changes in rates.

• Rolling and Layered Hedge – this approach is applied to reduce the uncertainty of cashflows. Eg: hedging a set % of annual FX exposure each month or quarter for future periods. This approach delays the impact of changes in exchange rates and creates more gradual changes ie: smooths the exchange rate curve.
The most efficient way of hedging uncertain exposure is by purchasing a Vanilla Option.

This is because the risk incurred is limited to the premium paid regardless of the outcome on the underlying exposure.

Purchasing Vanilla Options is most efficient if the probability of exposure materializing hovers around 50% (i.e. when it is at its most uncertain).

To reduce the premium cost of options alternatives such as purchasing cheaper out-of-the-money (OTM) options or using a combination of buying and selling options may be used to reduce the cost.

An optimal use of FEC’s and Vanilla Options is shown in the below diagram.
Optimal use of Hedging Instruments

<table>
<thead>
<tr>
<th>Estimated Probability of Exposure Materializing</th>
<th>Optimal Hedging Mix</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above 80%</td>
<td>Mostly Forward</td>
</tr>
<tr>
<td>60%-80%</td>
<td>Mostly Risk Reversal (Collar)</td>
</tr>
<tr>
<td>30%-60%</td>
<td>Mostly Purchased OTM Options</td>
</tr>
<tr>
<td>10%-30%</td>
<td>Mostly Call Spread</td>
</tr>
<tr>
<td>Less than 10%</td>
<td>Mostly Unhedged</td>
</tr>
</tbody>
</table>
Key trends leading treasuries are adopting

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Six Pillar Treasury Model

Treasury Conceptual Framework: ‘Six Pillar’ Model

1. Treasury Framework & Governance
   - Organisational structure
   - Roles and Responsibilities
   - Policies and procedures
   - Risk Management Framework
   - Infrastructure and systems

2. Financial Risk
   - Interest Rate Risk
   - Counterparty Credit Risk
   - Foreign Exchange Risk
   - Commodity Risk
   - Energy Risk
   - Insurance

3. Funding
   - Financial Planning
   - Source of Funding
   - Terms & Conditions
   - Loans Management

4. Liquidity & Cash
   - Managing Daily Cash Position
   - Managing Internal Liquidity
   - Periodic Cash Flow Forecast
   - Managing Banking Relationship
   - Bank Account Structure

5. Operations
   - Inter-Company Settlements
   - Treasury Settlements
   - Bank Reconciliation
   - Accounts Payable
   - Accounts Receivable
   - Accounting and Tax

6. Reporting
   - Cash Flow Report
   - Loans Report
   - Investment Report
   - Foreign Currency Report
   - Exception reports
   - Board reporting
Holistic Assessment of a Treasury Function

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<tr>
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<tbody>
<tr>
<td>Treasury not separate from Finance</td>
<td>Separate Treasury, informal Policies &amp; Procedures</td>
<td>Separate Treasury, formal Policies &amp; Procedures</td>
<td>Advanced teams with enforcement of governance</td>
</tr>
<tr>
<td>Virtually no formalised risk management</td>
<td>Reactive approach to financial risk management</td>
<td>Standardised approach to financial risk management</td>
<td>Advanced and proactive approach to financial risk management</td>
</tr>
<tr>
<td>Obtain funding if possible</td>
<td>Reactive funding using a loan by loan approach</td>
<td>Partially predictive funding model approach</td>
<td>Fully predetermined funding model</td>
</tr>
<tr>
<td>Reactive – no formal planning</td>
<td>Reactive and rudimentary cash management</td>
<td>Formalised treasury with formal and automatic cash management</td>
<td>IHB approach with minimal external bank a/c’s</td>
</tr>
<tr>
<td>Manual reactive approach</td>
<td>Semi automated reactive approach</td>
<td>Automated transactional approach</td>
<td>Straight through approach</td>
</tr>
<tr>
<td>No reporting</td>
<td>Rudimentary approach – manual data extraction with limited analysis</td>
<td>Semi automated with analysis</td>
<td>Highly automated with dashboard reporting</td>
</tr>
</tbody>
</table>

- Current State
- Better practice goal
Key Trends Leading Treasuries are adopting

- Strategy – being linked to the business – use the markets and not be driven by the markets
- Expanded treasury responsibilities – People down – task up
Key Trends Leading Treasuries are adopting

- Treasury Risk Management Policy in sync with organisation wide Risk Appetite statements
- Linking technology
Key Trends Leading Treasuries are adopting

- Payments – same day or nothing – in country and cross country
- Data analytics – peeling back the access to more data
Thank you for attending today’s talk

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