Safety nets

Jackie Bowie (pictured) and James Stretton of JCRA explain why current market conditions make hedging FX and interest rate risk all the more important.

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Hedging financial risk has always been an element of any private equity transaction, particularly when protecting against rising interest rates. Before 2009, higher interest rates meant that any hedging strategy was crucial to keeping interest costs under control and ensuring any covenant test of interest costs to EBITDA could be met. However, in many transactions it was little more than an afterthought, hastily executed once the more important aspects of the transaction were complete. In today's environment its status has been elevated in the deal process.

Jackie Bowie

Making interest rate hedging a mandatory part of a loan agreement is not a new phenomenon, but in the heady days of buoyant lending, lenders sold interest rate derivative products and borrowers soaked them up, with few questions asked about how appropriate the structure was, or in fact, how it was priced. The 'boiler plate' hedging strategy was to hedge two thirds of gross debt, and in all but a few exceptions, this hedging strategy was in the form of fixed rate swaps. Little attention was paid to how effective this instrument was in relation to the business plan objectives.

In the current environment, lending margins are substantially higher, and rising still. Not only are loan margins higher, so are the dealing and credit spreads that banks apply to swaps and other hedging instruments. Controlling the underlying cost of funds via a well-structured interest rate hedge could 'absorb' some of those margin increases, leading to a very competitive, overall cost of funds.

In addition, some borrowers have been caught out with hedging strategies which allowed them no opportunity to benefit from the unprecedented fall in interest rates. As interest rates were slashed, the simple vanilla fixed rates left them paying much higher levels than the market was now offering, and this opportunity cost was significant, especially if other areas of the operational business were under pressure. Today's private equity investments are likely to be held for longer periods, and in a much more uncertain environment. Simply hedging two thirds via a fixed rate swap is not a suitable structure. The hedging should be able to accommodate buy and build strategies, greater uncertainty over exit timeframes, and the market conditions that might be prevailing at that time. All of which is, or should be, influential, in determining an appropriate hedging strategy.

In today's interest rate environment, some borrowers can be reluctant to hedge at all; basing their decision on the fact that interest rates are expected to stay lower for a longer period of time. In a risk management world however, this is exactly the best time to hedge, allowing flexible hedging strategies to be entered into at very attractive levels. PE backed businesses are definitely exploiting this and are able to protect their cost of funds at levels significantly below that assumed in the financial modelling. Also, as we saw on the way down, interest rates can move fairly rapidly, and against all expectations. Why take the risk when the cost of protection is so cheap?

James Stretton

The hedging of FX risk is not quite so straightforward, nor as widespread as hedging interest rate protection. One of the reasons for this is that FX hedging is rarely a mandatory condition of a loan. This in itself would indicate therefore that FX risk is less likely to impact financial performance, when in fact the opposite is true.

Following the extraordinary increase in volatility in 2007-2008, the FX markets remain particularly skittish. In recent weeks, we have seen unprecedented movements in EUR/CHF – leading to 'line in the sand' type intervention from the Swiss National Bank, the like of which has not been seen for over 30 years – some flight into the USD and new highs (and record-breaking falls) in the gold price. Perhaps surprisingly given the ongoing shenanigans in the eurozone, both EUR/USD and EUR/GBP have been relatively stable.

Prior to the credit crunch, when leverage was easily accessible and stronger growth and confidence meant that aggressive IRRs were more readily obtainable than in the current markets, adverse FX movements on international investments, though potentially damaging, were in many cases more than offset by underlying equity performance. This was particularly the case for buy-out funds. The current environment, however, deals a 'double whammy' in that less spectacular returns threaten to be more easily overturned by adverse FX movements. This can be a particular issue in the lower return environment of the infrastructure fund.

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Unfortunately, the cost of hedging has increased. The rise in implied volatility has resulted in an increase in credit utilisation from existing hedges, and means that options too have become prohibitively expensive for some. This means that some GPs have had to put FX hedging on hold for the time being, at a point when very few forecasters feel at all confident about their predictions. Not to take out protection against adverse FX movements on the basis that hedging costs have risen, however, might be regarded as akin to foregoing car insurance on the basis that a recent spate of thefts has led to a rise in premiums.

For some of the larger players, FX exposure remains less of an issue. Firms making international investments can fund foreign assets in foreign currency to create a natural hedge. Furthermore, residual exposures may be viewed as a portfolio, with, for example, USD, EUR and GBP-denominated net assets forming a basket of currencies, though such a basket will nonetheless exhibit considerable volatility over time, whatever the reporting currency.

There is a sense of unease surrounding the hedging of medium to long-term investments, in that hedging appears to make more sense than ever but is also commensurately expensive. However, PE houses are increasingly hedging the relatively short-term pre-acquisition risk that occurs between signing and completion. In order to avoid option premium, this hedging is often effected through deal contingent forwards (DCFs) which allow the house to protect itself against an adverse FX movement between signing and completion, while crucially not committing itself to deliver on the hedge should the deal fail to complete as a result of a pre-defined contingent event. Though often extremely useful, DCFs will not be available for every deal. For example, a bank will be unwilling to quote a DCF unless it is very confident of the successful completion of the transaction. For this reason, before quoting, a bank will need to be 'close' to the deal such that it can make an informed judgement on the contingent risk.

Although PE houses investing overseas will often run significant unhedged translation exposure, they will usually insist on fairly rigid discipline from the finance directors of their investee companies when it comes to hedging transaction risk. This is partly due to the fact that hedging the transaction risk associated with imports and exports is usually shorter term in nature, meaning that hedging costs – whether represented by option premiums or credit consumption – are lower, and partly because credit line for hedging corporate FX transaction risk is typically negotiated as part of the overall debt package prior to the PE house's acquiring the investee company.

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