

PE firms creating bidding wars over contingent forwards

Deal-contingent trades, which allow PE houses to hedge their FX risk, have seen a strong revival recently, creating stiff competition among banks.

Susannah Birkwood reports

Private equity firms investing in foreign companies are creating bidding wars among banks determined to entice them into signing contingent-forward contracts.

The competition among banks is driven by a marked rise in investors looking to hedge their foreign currency exchange risk in recent months. “There’s certainly been tremendously frenetic activity on the private equity side,” says Richard Bailey, global head of FX Trading at Société Générale. Private equity houses are in a very strong position, having realised how useful these deals are for cash-strapped banks looking to make a profit without committing capital.

Deal-contingent forwards (DCF) allow clients – who are almost exclusively private equity firms – to exchange one currency for another at a specified rate on a future date. There appears to be an increasing recognition that DCFs provide a convenient halfway house between options and forwards, by protecting PE houses from adverse FX movements without locking them into a potentially loss-making forward contract should their deal not complete.

This isn’t the first time that DCFs have been perceived as an attractive proposition for private equity. “They were hugely popular in 2006-2008, which is when they started to become really active,” says Bailey. “Back then there were only three or four banks quoting in that space though, and then 2008 happened and all went quiet. Now there are eight or nine banks which want to quote.”



Much of the impetus behind this resurgence is the highly increased levels of volatility in the FX markets. It all began in March, when a Japanese earthquake led to a collapse in dollar/ yen to the extent that daily moves unlike anything seen since early 2009 were reported. The Eurozone crisis also continued to loom, providing a constant underlying threat to the world’s second biggest reserve currency, while the downgrade of the US’s credit rating by Standard & Poor’s, and significant turbulence in the Swiss franc have provided further cause for concern.

Meanwhile, the UK’s high-yield bond market experienced an exceptionally bad start to the month, leaving many banks with unsellable bridge loans and reducing the likelihood of them lending much to PE houses. Presumably this will cause a number of deals to fall through, making DCFs

and other ways to safeguard against this even more popular. “Clearly that has a direct impact,” agrees Bailey. Jackie Bowie, a director at financial risk adviser JC Rathbone Associates, adds: “I would expect uncertainty in markets to lead more people to think about the risks of their deal not closing and how they may protect themselves against that.”

While seemingly an ideal solution for internationally-focused GPs, DCFs could be giving banks a raw deal.

According to Bailey, the aggressive pricing to win this kind of trade is reaching a tipping point, and may no longer be worthwhile. “Those banks which have been doing this for years

contingent forwards

are now starting to feel a bit uncomfortable because of the tremendous volatility,” he reveals.

“The margins which used to be relatively comfortable are now reduced to a sliver.” The major downside for the bank is where the deal does not complete, because it is not possible for them to lay off this risk in the same way as with a normal forward or option trade. “For this reason, a bank will only quote a DCF if it believes there is a very high probability of a successful completion,” points out James Stretton of JC Rathbone Associates.

But despite these disadvantages to banks they will continue to offer DCFs, as they allow them to build more general relationships with buyout houses. It is not unusual for the institution which wins the DCF auction to go on to run the sales process for the PE firm’s next exit or source its next deal. “The banks which do this may have their capital markets division

very much aligned with their corporate finance division,” Bailey points out. “Obviously that can bring huge rewards.”

Whether or not PE houses feel the need to enter into a DCF, Bailey believes investors should exercise caution when contemplating not hedging FX risk. The sharply increased volatility means that firms could have values sliced off their return, or returns wiped out entirely “not quite in the blink of an eye, but certainly over the course of a month or two”. Indeed, allowing sufficient time is said to be crucial to an efficient DCF. “Getting legal documentation agreed to both parties’ satisfaction can be very time-consuming, particularly where more than one bank is involved,” says Stretton.

Bailey recalls how the Swiss franc moved 12% in a day versus the Mexican peso a fortnight ago. He warns: “When currencies are this volatile, it is something that cannot be ignored.” ■

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