

Border patrol

PAUL SILLS OUTLINES THE CHALLENGES OF HEDGING CURRENCY AND INTEREST RATE RISK FOR A CROSS-BORDER ACQUISITION, WHILE **TOM GILLIAM** ADDS AN INSIDER'S VIEW OF HOW SABMILLER TACKLED THE PROCESS IN ITS PURCHASE OF FOSTER'S.

The standard approach to risk management is to identify, measure and manage exposures within the overall framework of treasury policy. Although this approach clearly holds in M&A situations, the very contingent nature of these exposures may require more dynamism and high-level co-operation in formulating a deal-specific hedging policy and strategy. Each deal is unique and so it follows that a hedging solution should be tailored to match the inherent risk of the individual acquisition.

CLOSURE One of the most challenging aspects of hedging an acquisition revolves around the uncertainty of the deal in terms of probability and timing of closure. To develop a hedging strategy, the treasury team will first need an estimation of the probability of closure – provided by the board based on its negotiations with the target's board and the premium included in the cash offer price – which can then form the basis of a hedge ratio (the percentage notional exposure to be hedged relative to the overall exposure). The timing of closure is dependent on shareholder approval and regulatory consent and so can vary significantly. Here, estimations can be taken from similar deals in the marketplace.

It is important to note the dynamic nature of probability of closure, which requires continuous assessment. As each significant regulatory and shareholder hurdle is passed, the probability of closure increases and the hedging strategy may need to be adjusted.

CONTINGENT PURCHASE PRICE Cross-border acquisitions involve a number of financial risks which the treasury team will identify: contingent foreign exchange (FX) exposure to the purchase price, interest rate exposure from the requirement to raise debt, counterparty risk on derivatives, settlement risk, and translation exposure from consolidation of the target's balance sheet and income statement should the deal close.

The most salient of these risks is the contingent exposure to the purchase price. FX movements could have a significant impact on cashflow by varying the acquisition price in domestic currency terms. It is advisable to measure the validity of this risk by simulating the impact of exchange rate fluctuations on available liquidity. Using VaR (value at risk) analysis, at a 95% or 99% confidence level, treasury could calculate a worst-case scenario and determine if the risk merited hedging.

A number of strategies can be used to hedge the contingent purchase price, some of which will not be covered by existing treasury policy. However, in an acquisition situation the board may authorise the use of exotic products or allow option premiums to be paid up to a certain nominal level in order to achieve the best hedge. The accounting impact of the hedging strategy must also be considered and authorised. Forecast transactions that are not highly probable may not qualify for hedge accounting and therefore will have an impact on the income statement.

The strategy could be to do nothing. If the acquisition fails, the acquirer walks away unscathed. If it succeeds, the purchase price will be paid for at prevailing market FX rates. But can this strategy be justified with elevated levels of FX volatility? An appreciation of the foreign currency will make the acquisition more expensive in domestic currency terms, so the acquirer would need a significant liquidity backstop.

STRATEGY FX forwards are the standard market product for negating transaction exposures and would lock in the cost of the acquisition in domestic currency terms (and therefore any domestic funding requirement). However, a forward highlights the problem of using a product with a symmetric pay-off to hedge FX risk stemming

from a contingent event. If the acquisition fails, the acquirer is left with a speculative FX position, the unwinding of which could lead to significant gains or losses being recorded in the income statement.

This leads us to vanilla options, which are asymmetric products. The acquirer could purchase a call on the foreign currency. A worst-case scenario is known and the acquirer can participate in unlimited upside potential from a depreciation of the foreign currency. If the acquisition fails, the option is still likely to have residual value. Option premiums are often seen as expensive but the cost can be reduced by purchasing "out of the money" calls, using barriers, or selling options to create vanilla option structures such as risk reversals. The purchase of a compound option (simply an option on an option) will reduce the initial premium but if the compound option is exercised the combined premiums will turn out more expensive than the plain-vanilla option. Compound options are most suitable when there is a high level of uncertainty.

Contingent forwards and options are products contingent on the underlying acquisition taking place. In a deal contingent forward the fixed exchange rate will be at a premium to the "at the money" forward. The size of the premium largely reflects the probability of the acquisition closing, so this type of product is usually offered by banks with an intimate knowledge of the acquisition. If the deal fails, neither party has any further obligations under the forward contract. In risk terms, they are a perfect fit, but they may not be available and can be prohibitively expensive.

A portfolio approach using options, options structures and FX forwards may be the most cost-efficient solution. The critical factor to remember in designing the hedging portfolio is that it defers to the probability of close (hedge ratio), acquisition timeline and significance of the risk.

WHEN TO HEDGE The commencement of the hedging programme is often a reasonably subjective decision and may be instructed by the board. Should it start before or after the deal is announced, when certain regulatory hurdles are passed, when shareholder approval is attained or because the FX rate is at a historically attractive level? If the envisaged acquisition timeline is very short, it may even be considered after the letter of intent is drafted (along with the formation of the bank acquisition facility). An awareness of the impact of "deal announcement" and of the market hedging process on the relevant currency pair is also required. Large acquisitions in illiquid currencies could have significant effects on market price.

THE SABMILLER EXPERIENCE SABMiller faced the above predicament when hedging its recent acquisition of Australian brewer Foster's. The deal was backed by the Foster's board in September and closed in December; during this time the exchange rate of the Australian dollar with the US dollar was extremely volatile, trading in the range 0.95 to 1.07. On a deal of nearly \$11bn this sort of FX volatility could have had huge implications on the overall cost.

SABMiller built up its hedging cover over the course of a number of weeks to avoid causing any market impact. To hedge the deal it initially used a blend of option-based products. Volatility was high throughout the period, as was the currency skew, which allowed the

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use of risk-reversals as a cost-effective hedging tool. Once the deal was pretty much certain, the remaining cover was built up via outright forwards.

BONDS An acquirer may raise contingent foreign currency debt by arranging a facility provided by a pool of banks and refinance later by issuing a foreign currency bond. The foreign currency debt can be used as an asset-liability hedge (reducing translation exposure) and to minimise net free cashflow in the foreign currency, as a result limiting the effect of exchange rate fluctuations on the value of the business.

In some cases the foreign currency bond market will not have the capacity to deal with a large issue or there may be a preference for the acquirer to issue in its home market due to cost and liquidity. Debt can be transformed into synthetic foreign currency debt using a cross-currency swap, but consideration needs to be given to liquidity and spreads in the basis swap market, use of bank credit lines, counterparty risk and swap credit margins. Alternatively, debt can simply be exchanged into the foreign currency and the currency exposure left unhedged.

The requirement to raise debt exposes the acquirer to interest rate risk. If the deal is highly leveraged then prehedging of the debt issue should be considered to protect interest rate costs and covenants; VaR analysis can be used to estimate a worst-case scenario. The strategies employed in hedging interest rate risk will be very similar to those already discussed in FX: do nothing, use forward starting swaps, swaptions, caps, floors, collars (and combinations of these products) or deal-contingent structures.

TRANSLATION EXPOSURE If domestic debt is raised and exchanged in the spot market to pay the purchase price, the acquirer will be exposed to translation exposure from consolidation of the target's balance sheet and P&L account (though existing debt on the target's balance sheet may act as a hedge) and to net free cashflow in the foreign currency required to pay interest costs on domestic debt. Whether or not to hedge, or partially hedge this exposure post-acquisition usually depends on organisational policy.

Since an acquisition is a long-term investment many companies would consider it not in their economic interests to hedge the currency exposure – in other words, FX movements are a zero-sum game in the long run. This strategy may also avoid the cost of carry associated with the net investment hedging of certain foreign subsidiaries. However, there are two main caveats: protection of debt covenants and credit ratings.

To find out more, visit the workshop on "Currency risk management in cross-border acquisitions" at the ACT Conference.

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