HEDGING YOUR BETS

Do you have appropriate hedging strategies in place?

A large number of variables will continue to impact future exchange rates, meaning there will be uncertainty for some time to come

While the full regulatory and economic impact of Brexit will take some time to play out, it has had an immediate effect on the value of the pound, with increased import costs the most significant immediate issue for most of our private equity clients as they consider their portfolios in light of the Brexit decision. Private equity firms and their investee companies will now potentially find themselves with a level of FX exposure that did not previously exist.

There has been considerable commentary on the market swings to date and the likely future value of the pound, alongside the general speculation as to just how long the Brexit process will take and the ultimate deal that will be struck between the UK and the EU on a whole range of trading, economic and political issues. The only thing that can be said with any certainty is that there are a large number of variables which will continue to impact future exchange rates, meaning there will be uncertainty for some time to come. It would therefore be trite to say that investors who had not adequately hedged their portfolio companies are too late given the depreciation of the pound that has already arisen – it seems likely that fluctuations will continue over a period of years as the Brexit process plays out.

Our discussions to date with PE firms in this area have broadly fallen into the following categories:

- **Currency risk for portfolio companies**, ie. how will currency fluctuations impact their expenditure and revenue across the jurisdictions in which they operate. The sector which has seen the most significant impact is, unsurprisingly, retail and consumer given the heavy reliance that is often placed on importing goods and raw materials from jurisdictions with a US dollar exposure.
- **Currency risk for the PE funds themselves** in light of the identity of their investors, ie. how will currency fluctuations impact the investment returns achieved by their overseas LPs, and what additional scrutiny or other interactions with those investors might be expected in light of that?
- **Information requests from investors.** LPs are asking their GPs for varying degrees of analysis as to the exchange rate exposure within their portfolios – we have heard of everything from a 2 page summary on the entirety of the portfolio to detailed reporting on an asset by asset basis. PE firms may require investee companies to provide regular turnover and import cost data on a jurisdiction by jurisdiction basis, so that this can be compiled and passed back to investors in their funds.

There are various proactive steps that investors can take to mitigate the risks

- An increased emphasis on FX issues can be expected when conducting **due diligence on new deals**, with suitable hedging products taking a greater significance as part of any banking package. This may well mean that certain lenders are better placed in the market than others to provide financing on deals generally, given there is often preference for both acquisition finance and ongoing banking facilities to be sourced from the same lender(s).

There are various proactive steps that investors can take to mitigate the risks that arise in this new environment including:

- As a starting point, a **review of current currency risks and associated hedging strategies** across all jurisdictions in which an investee company operates. Consider if increased hedging lines are required. Explore FX hedging strategies with hedging experts and legal advisors.
- **Review existing hedging documentation** to consider if any of close-out events may have been triggered - in particular, review Additional Termination Events for triggers such as rating decline and any Increased Costs of Hedging provisions. Market Disruption Events, or Change in Law provisions (which are unlikely to be triggered, but it is worth checking).
- **Representations given under banking documentation should be checked** to ensure they are/will still be correct. Financial covenants and other financial tests and thresholds should also be tested, to see if they are impacted by exchange rates. New banking facilities should include provisions whereby undertakings, representations, baskets and events of default are not tripped solely as a result of exchange rate fluctuations.
- **Counterparties may wish to change** the branch or subsidiary they trade out of and make other amendments to reflect Brexit concerns (eg. flexibility to transfer derivatives in the future).
- **Review collateral arrangements** – what are the minimum credit ratings of eligible collateral, is more collateral required due to market movements in value of derivatives?
- **Incorporate a review of FX exposures** on future due diligence exercises, and tailor the ongoing banking requirements of any new investments accordingly.
- **Mandatory clearing requirements may need reviewing** eg, will it still be possible for non-EU entities to clear through UK central clearing counterparties?
- **Consider cash pooling arrangements and other treasury arrangements** where currencies are automatically converted into GBP

Who to contact and how we can help

ALEX DUMPHY
Partner

020 7160 3221
07709 332374
alex.dumphy@addleshawgoddard.com

MARTIN O'SHEA
Partner

0161 934 6403
07775 586372
martin.oshea@addleshawgoddard.com

We advise clients on all issues arising from currency exposure including:

- Review of hedging and margining documentation
- Hedging review in due diligence exercises
- Advice and negotiation of new hedging documentation
- Workshops with clients alongside hedging advisers (who we can introduce where necessary) to consider appropriate hedging strategies for companies across a full range of sectors.