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M&A: Interest Rate & FX Risk Management

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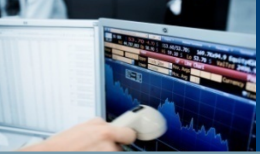


M&A Risk Management – Timing Considerations

Generic Acquisition Timeline

Approval and execution of corporate strategy

Case assessment and contact to financing sources

Orientation of the Board

Initial Offer

Completion of due diligence and financing

Empowering of mgmt and handling of impediments

Final bid

Complete red binders

Finalise Funding details

SPA Signing

Competition Authorities review

Shareholder Approval

Funding drawdown

Deal Closing

Risk Management Considerations

Perform Asset/Liability Management Analysis on the CombinedCo financial Risks

Finalise the currency mix of acquisition funding package based on the results from the ALM analysis

Certainty of deal increased: Possible to use forward based hedging strategies

Convert equity and debt funding proceeds to settlement currency

Consider using Options to limit downside to purchase price

Roll potential FX Options or rate swaption into (Deal Contingent) FX Forwards or rate swaps

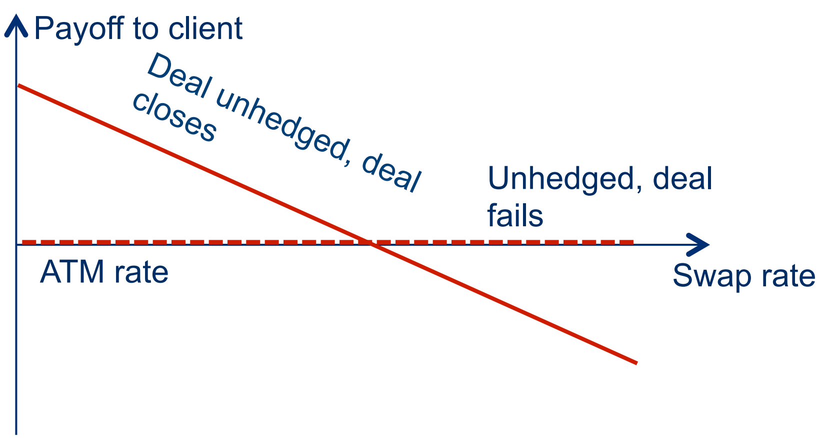
Deal Contingent IR Swap

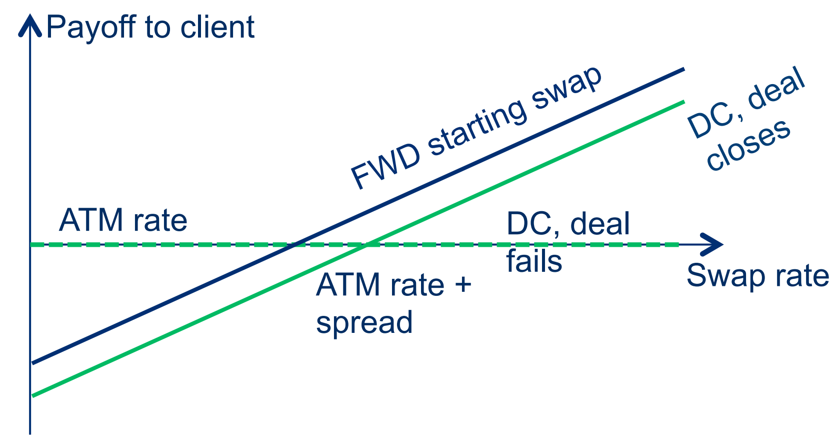
Unhedged

- Exposure to interest rate fluctuations while target decides on offer
- Risk of considerably higher interest expenses throughout the M&A process.
- Risk of breaching interest rate covenants at settlement

Hedged: Deal Contingent vs. Vanilla IR Swap

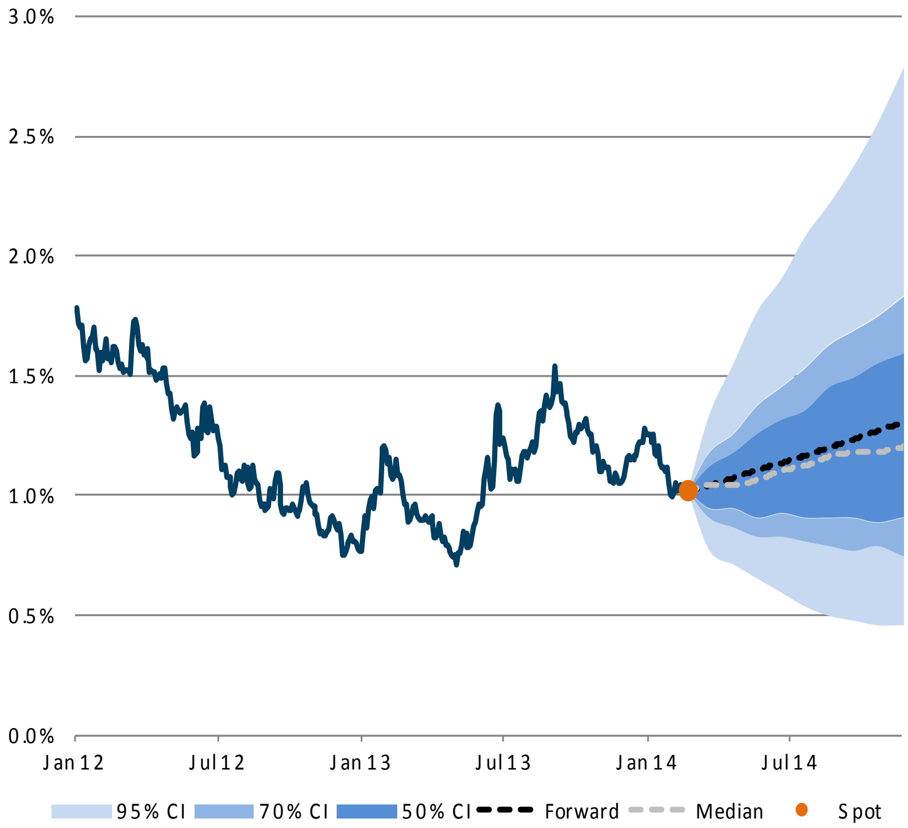
- The fixed rate in Deal Contingent (DC) swap is higher than forward swap [spread], but no downside risk for client if deal does not close
- The spread to forward rate is the "price" of the DC swap.
- CVA implications
- Typical discount of 15-50% to price when using a DC swap compared to buying ATM swaption





Why pre-hedging interest rate costs matters .... short-term risk

Market implied risk to 5Y EUR swap rate

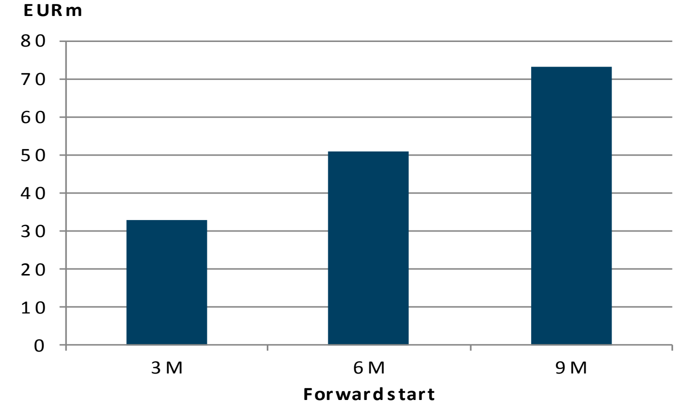


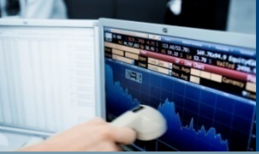
- Volatility in the 5y swap rate could potentially send the swap rate significantly higher in 3-12m than implied by today's forward curve.
- In an acquisition scenario a large rise in swap rates can significantly impact the profitability, risk to covenants etc. Though, whether the hedge is deal-contingent or not, a forward starting hedge could potentially save a significant amount of basis-points.

Forward start	Worst-case*, bps
3M	+66
6M	+102
9M	+146

- * Worst-case defined as the difference between forward curve and 97.5th percentile.

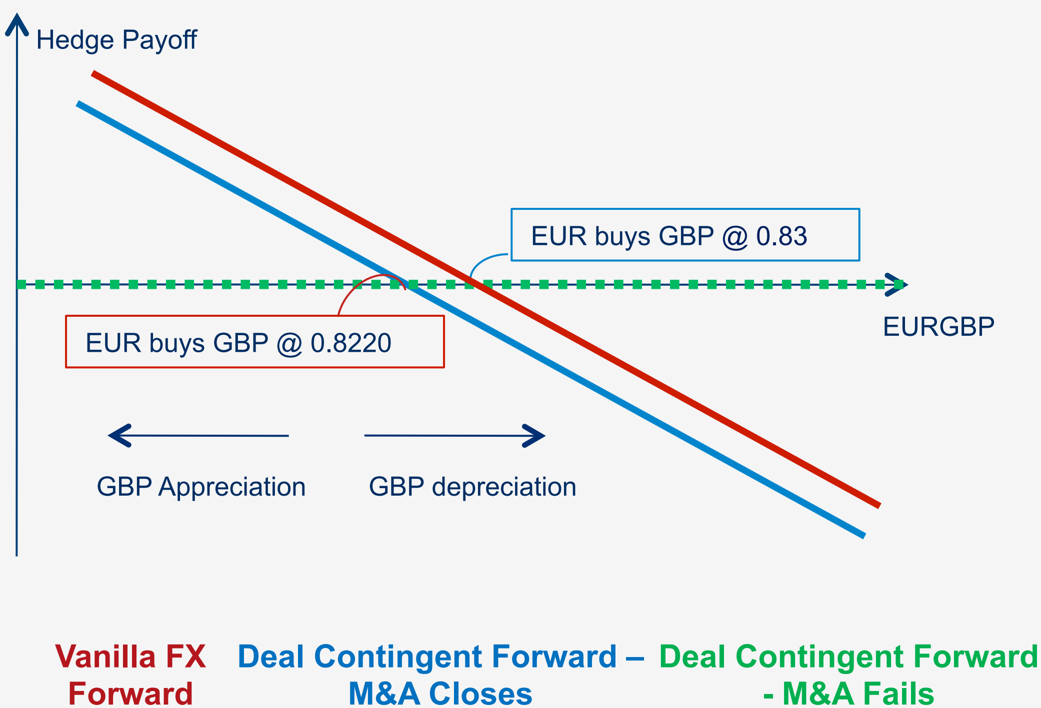
Worst-case additional interest rate costs on a 5y loan of EUR 1bln





Deal Contingent FX Forward – Payoff Illustration

Payoff Structure (From EUR corporate perspective)



Deal Contingent FX pricing 3M

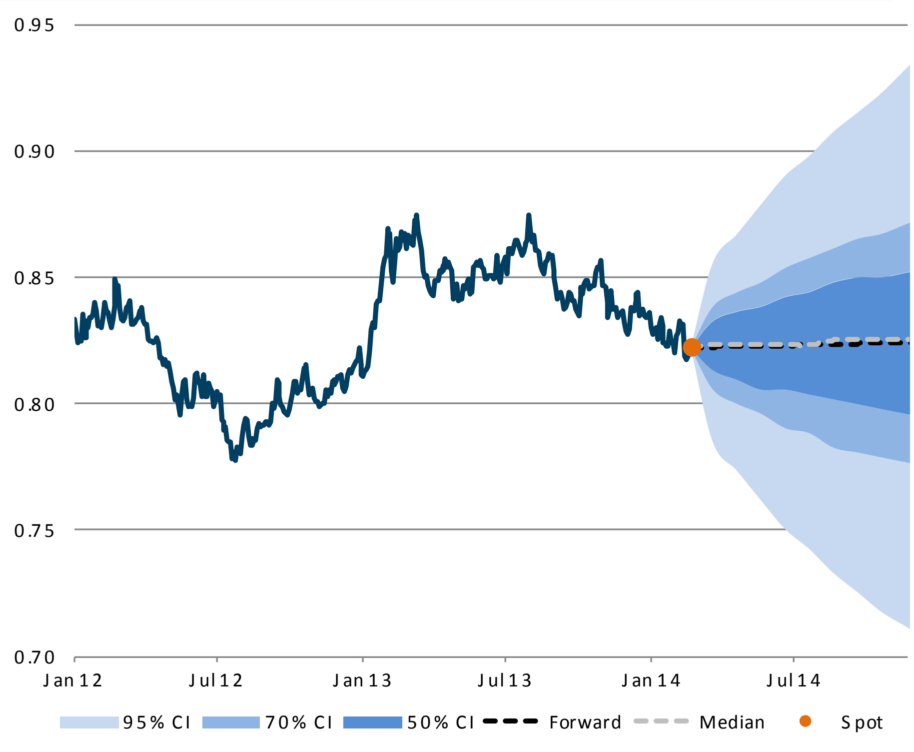
- **If deal closes, the company buys GBP at 0.82**. The Deal Contingent premium is the difference between the Deal Contingent Forward rate and the vanilla forward rate
- Limited credit implications
- **If no deal, the contract is cancelled**
- Typically the Deal Contingent Forward will be cheaper than buying a vanilla option, but more ”expensive” than the vanilla forward
- Premium is calculated by using the price of an ATM vanilla option with the requested maturity and applying a discount of typically between 15-50% depending on deal specifics (closing probability etc.)

Risk to Purchase Price - FX

As an example: EUR corporate buys a UK company

- FX is often the major financial risk in an M&A situation, whether to price, valuation or covenants
- This risk can have a significant impact on the purchase price even on short horizons while waiting for **shareholder** and/or **competition authority** approvals
- **If EUR corporate is buying UK co. they face an implied risk on the GBP of around 7.5% over a 3-month period**
- **In context of the acquisition economics, assuming a purchase price equivalent to a EBITDA multiple of 10x, EUR Corporate is betting the first 9mths of new EBITDA on the FX rate, if they do not hedge any non GBP funding sources**
- **If this had been a normal "operational" cash-flow this type of risk would typically be something a Corporate would hedge**

Market implied risk to EUR/GBP



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Hedging FX & IR Risk in M&A Situations

	Spot	Forward	Option	DC Forward
Upfront payment	No	No	Yes - potentially expensive	No
M&A deal closes	▪ EUR is exchanged to GBP and IR swaps are made at settlement ▪ **Large downside risk of GBP appreciation and rise in swap rates**	▪ Perfect hedge of FX and IR "*if*" deal settles as planned. ▪ No potential upside	▪ FX options and IR swaptions cap worst-case rates ▪ Exercise options if I-T-M ▪ Potential upside	▪ **Perfect hedge;** a DC premium is paid compared to vanilla forward rate ▪ No potential upside but also no potential downside
M&A deal fails	▪ No transactions since no deal ▪ Hence, no risk	▪ **Forward contract must be settled** →*Huge downside risk if deal fails*	▪ No deal, premium has been paid, however there is potential profits from I-T-M options	▪ Hedging contracts are cancelled → Both parties walk away ▪ Hence, no risk

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