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Ehata Financial Company

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MANAGING INTEREST RATE

And FX Risk for Project Finance & Cross-Border M&A Transactions

We don't have to go so far back in time to realize how unanticipated Interest Rates or Foreign Exchange events have drastically disrupted project finance and M&A transactions prior to their official close.

We have all witnessed very recent major events, such as Brexit, EURCHF unpegging and lately Turkish Lira sell-off, which have caused and are still causing catastrophic implications on the economic value of these transactions.

Hence, treasury managers and CFOs aim always to mitigate and manage the different market variables that could impact the intended project finance or M&A transactions.

TRADITIONAL HEDGING APPROACH (PRE-HEDGING)

Companies used to hedge their exposure in these transactions by applying a pre-hedging mechanism, where the instrument is used to hedge the underlying exposure. For example, a project finance transaction would always have the open market risk between the periods of signing and closing, whereby sponsors may opt to execute a forward starting Interest Rate Swap (IRS) matching the expected finance close date or alternatively buy a swaption (the right to enter into an IRS at a future date).

The aforementioned examples offer certainty in terms of locking-in the market rates. However, there are no guarantees on whether the project finance transaction would go through or not, while at the same time there is an outstanding hedge with potential collateral implications or hedge premiums required to be paid.

The same idea applies for an acquisition transaction, where a US-based acquirer may wish to hedge the EUR cash payment to be made to an EU-based target. The payment would normally be obligatory once due diligence and regulatory approvals are completed, where necessary.

Hedging such FX risks used to be typically via executing simple FX Forward or buying an FX option, where a premium is required to be paid.

Again, if for whatever reason the deal does not go through, the acquirer would be exposed to an open FX position that could have a deeply positive or negative Mark-to-Market (MtM) value, thus adding a burden (in the case of FX Forward) or a premium payment (in the case of option purchase).

A PRACTICAL SOLUTION:
Deal-Contingent Hedging

A very practical and straightforward approach in hedging these uncertainties surrounding such market risks is **Deal-Contingent Hedging (DCH)**, which has become increasingly popular globally.

The idea in its simplest form is to allow the stakeholders to hedge their market risk in project finance or M&A transactions while avoiding dead-deal hedging costs.

For example, an acquirer may engage in an FX forward transaction that is contingent to the cross-border acquisition deal actually happening.

If a regulatory approval could not be obtained or certain due diligence failed to be satisfactorily met, the hedge disappears without any obligation or liability on the hedger.

In general, a project finance transaction would have a certain long-term debt profile dedicated to financing the project, however the quantum of which may be undefined until close to financial close, due to changing conditions around market interest rates.

One of the major determinants of this amount is the debt service coverage ratio (DSCR), which uses a fixed interest rate attained to measure the project's cash profitability in meeting its debt obligation.

The project company will incur an extra cost if the interest rate increases more than what has been assumed in the model, which would potentially force the DSCR to go lower.

In this case, the lender may reduce the size of the committed debt, thus shifting the economics of the whole project.

DCH provides the flexibility to avoid such a situation by immediately fixing this variable once signing takes place and the committed debt quantum is agreed.

A deal contingent forward starting interest rate swap can be efficiently used to hedge such exposure while having zero obligation if the project finance transaction fails. The only instance where a liability may arise is if the sponsor decides not to proceed with the transaction, unrelated to the contingent risk.

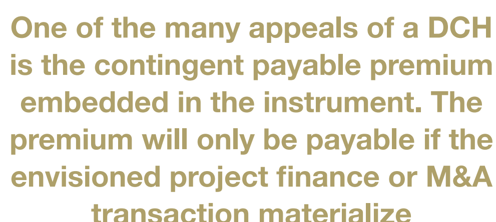
ADDITIONAL GROUNDS

One of the many appeals of a DCH is the contingent payable premium embedded in the instrument. The premium will only be payable if the envisioned project finance or M&A transaction materialize. This ensures that no obligation whatsoever takes place without completing the transaction.

The only difference between the two hedge approaches (pre-hedging and Deal-Contingent) from a pricing perspective, is the extra DCH spread cost charged by the hedge provider, which is due to its forthcoming flexibility.

DCH pricing, nonetheless, has recently decreased, due to the increased competition, popularity and ongoing market maturity.

Although this competition seems helpful for implementing the planned risk management approach, such hedging is more challenging to benchmark versus "off the shelf" hedging instruments, and thus companies that are not frequent users of such hedging will find it very difficult to determine the fair executable price.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DCH PROVIDERS APPROACH

From the perspective of a bank or a hedge provider, there must be a certain understanding of the business and making sure that hedger is genuinely incentivized to complete the transaction.

The hedge provider will have to understand the details of the financing structure and associated covenants. The premium or credit spread charged will also depend on how likely the transaction will go through within the specified timeframe.

Given the unique business nature of every project finance or M&A transaction, banks or hedge providers

are typically cautious when reviewing the details and documentation for every case due to the inherent risk on the open derivative instrument position, which the bank will solely be liable for in the event of a failing transaction.

The due diligence exercise becomes even more critical on the transactions where the bank or hedge provider is not part of the creditors or advisors pool. The closing probability will typically be the greatest risk factor, closely followed by the quantum of potential loss. The hedge provider may ask the company to adhere to specific covenants related to the hedge, which could include:

- Identified hedge documents not to be assigned.
- Key project parameters to be kept intact.
- Immediately notify the hedge provider of any event that would potentially delay the expected financial close.

Once financial close is reached, or the acquisition is completed, the hedger may elect to cash-settle the position and enter into a new hedge with the project or transaction lenders on a back-to-back basis.

It can very well be that the DCH provider transfers the hedge to the lenders along with some credit spreads on a pro-rate basis.

This is more relevant to the Saudi market where we see very limited offering of DCH. We believe that increasing market needs coupled with infrastructural projects in the Kingdom would trigger accelerating the development of such hedging approach.

In turn, local banks will have a competitive advantage to compete with international players due to the localized nature of the transactions.

Given the different hedge providers in such transactions, it is greatly advisable to carefully review the DCH covenants and conditions before engaging into the hedge.

The project company or hedger should be sure to commercially negotiate the terms in a manner that would not contradict with the existing documentation or lender covenants.

Carefully reviewing such terms will help avoid running into a situation where a termination payment is triggered even if financial close is not reached by the agreed timeframe.

CONSIDERATIONS

We have seen rare cases where hedge accounting treatment is applied to the Deal-Contingent Hedge. Normally, it is treated as per FVTPL (Fair Value through Profit or Loss) methodology within the period from execution until the debt is issued or transaction is completed, where then it can be qualified for hedge accounting. However, if the hedger can prove that the deal is highly probable, depending on how the auditor defines “highly probable”, then hedge accounting can be applied.

That sort of treatment is less relevant to private firms, where economic advantage is usually prioritized over any accounting implications.

Another consideration concerning M&A transactions is to go deeper in the analysis to better understand the newly created entity post-merge or acquisition, before executing the DCH.

The analysis should cover how market risk should be subsequently managed while optimizing any possibilities for natural hedging, which would offer less operational complexity and ensure the avoidance of any unnecessary hedging that might take place.

WHERE CAN EHATA FINANCIAL SUPPORT YOU?

Ehata Financial will be delighted to offer your firm or the project company access to a wide range of expertise within the Deal-Contingent Hedging space. We have developed a deep understanding of the process, which can be made efficient and transparent no matter how complicated the transaction is. Please reach out to us, and one of our advisors will be at your disposal to assist you. You can reach us at info@ehata.com.sa or visit our website www.ehata.com.sa

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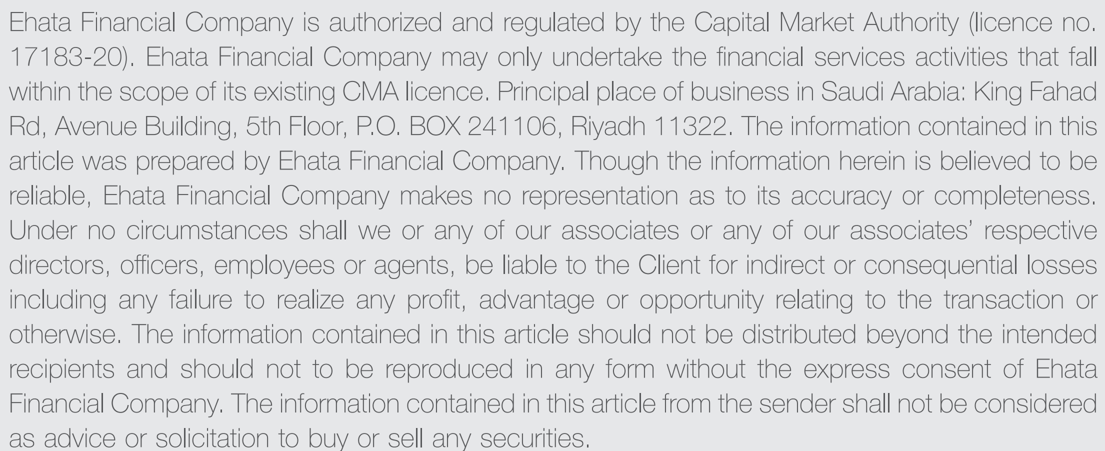

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