



International Outlook

A PUBLICATION FROM GPS CAPITAL MARKETS, CORPORATE FOREIGN EXCHANGE DIVISION

IN THIS ISSUE:

Cross Border Acquisitions, and the FX effect.



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FX considerations of a cross-border acquisition: part II

By Andrew Soong, FX Sales & Trading

In our July publication we addressed the FX risk of a cross-border acquisition in the context of purchase price and capital structure. In this month's issue we will touch upon the following related topics:

- Hedge accounting
- Deal uncertainty
- Products and strategies

Hedge Accounting

Clearly prohibited by FAS 133, a common point of frustration is the inability to affect hedge accounting for cross-border acquisitions. Any currency hedge associated with a forecasted acquisition will be marked-to-market and all changes in fair value will be recorded in income. Most companies are not thrilled with this prospect, but it is a hard reality and one that is preferable to the potential economic disaster should you choose to not hedge the purchase price. For public companies, this one-time, below-the-line gain or loss is widely received in the equity markets – it is transparent, common practice, and a rational decision to financially protect the purchase price. It is certainly a lesser concern for private companies who more openly prioritize the protection of cash flow over earnings.

Rare instances do exist where the acquisition risk can be hedged via a surrogate if the acquirer has existing net investments in foreign subsidiaries whose functional currency is the same as the denomination of the foreign target. This is unmistakably the exception rather than the rule.

Deal Uncertainty

Managing around deal uncertainty makes hedging an acquisition more challenging than most FX exposures. Many companies find themselves perplexed about how to hedge the purchase price of a cross-border acquisition, particularly when they are uncertain about the possibility of achieving a successful execution, which could lead them to ask why would they hedge a transaction when they don't



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even know if it will exist?

As we've mentioned in previous issues, a "do nothing" approach to FX purchase price risk is generally not feasible. Along those lines we have observed that experienced management teams will assign a risk-adjusted probability of closing the acquisition. This probability, at a minimum, can be used as a base for hedging the purchase price risk. Often we will see companies hedge this probability as a percentage of the notional value of the acquisition. For example, if management believes the deal has a 75% chance to close a \$100 million acquisition, the company may elect to hedge only \$75 million of the purchase price. As the acquisition process unfolds, this hedged amount can easily be adjusted to match changes in the probability of closing – albeit not at the original hedge rate, but instead at the prevailing market rate. While this approach may not prove to be ideal, it is a viable tactic in managing FX risk around deal uncertainty.

Determining when to hedge the purchase price can also be a challenge. Many acquirers will wait until the purchase-sale agreement is signed. Others may elect to hedge all or a portion of the risk prior to signing an agreement. Factors such as the sale process, achievable financing, regulatory hurdles, and comfort with the target's management team, all play a role in when to hedge. Timing ultimately remains a critical judgment call. The question is more easily answered depending on management's confidence and experience in this arena.

Products and Strategies

In very few instances do we recommend vanilla forwards to hedge cross-border acquisitions. This is primarily for two reasons: (1) mark-to-

market risk – unlimited gains/losses in income as a result of lack of hedge accounting and (2) unwind risk – unlimited gains/losses in income and cash flow should the underlying deal fail.

For these reasons, we more often turn to option-based strategies which are not nearly as penalizing as a forward. With a purchased option it is only the premium that is mark-to-market as opposed to the full notional value on a forward contract. Unwind risk is limited to the amount of the upfront premium should the acquisition fail. In addition, an option will provide unlimited upside potential for favorable currency movements, which could effectively lower the purchase price – an economic factor that cannot be overlooked. An option may even produce an unexpected profit if it is *in-the-money* should the deal cease to exist.

Opponents will argue that the upfront premium to purchase the option can often be viewed as expensive. However, there are several ways to reduce the premium expense, including: (1) setting the strike (protection rate) *out-of-the-money*, (2) examining average rate products, (3) hedging a smaller, risk adjusted notional amount, and (4) taking a portfolio approach – combination of forwards and options to reduce the mark-to-market and unwind risk to a more acceptable level.

The following are alternative option structures for cross-border acquisitions:

- Financing the option premium using *deferred-premium* products, or *zero-cost* option structures such as a Capped Risk Forward (a combination of three vanilla options) is frequently considered. Each has its merits although ultimately both reflect the economic cost and payoff of a



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vanilla option.

- *Deal contingent* products are periodically available for cross-border acquisitions, where the acquirer is given forward-like protection at a less favorable rate, but can walk away from the hedge (mitigating unwind risk) should the acquisition fail under predetermined conditions. Although not without value, we commonly find the hedge rates on deal-contingent products to be inherently and prohibitively unattractive.
- *Compound options* allow the acquirer to pay a fractional upfront premium for the right to purchase another option at a predetermined price. While the combined premiums of the compound option are greater than that of a single vanilla option, the product offers a distinctive alternative for hedging a defined deal probability.

Finally, each hedging product has its pros and cons. Likewise, each cross-border acquisition has its own unique set of circumstances. Finding a suitable hedging instrument to meet the needs of a cross-border acquisition is a critical step in managing the purchase price risk.