Silicon Valley Bank

Foreign exchange hedging for global fund exits

Short-dated foreign exchange (FX) forwards can be used to help mitigate the FX rate uncertainty that rises between the time a portfolio company is sold and the funds are repatriated back.

Situation

A USD-based fund has a European investment that has recently matured. The repatriation process can take up to a month before all docs are finalized. Although the final EUR amount figure is known, the timing of the repatriation is unknown. The timing on the transfer of funds back to the US can take anywhere from a few weeks to a couple of months.

Should EUR appreciate in the interim, the total return (investment yield + FX yield) will increase. However, should EUR depreciate before the final conversion, the total return will decrease resulting in a lower overall final IRR.

To eliminate potential losses due to currency fluctuation, FX derivatives are often used to mitigate this risk so that firms can focus solely on the investment-generated returns.

Potential size of FX rate movement

According to the long-term average price for an at-the-money option in the EUR/USD exchange rate[1], we can assign a 1 in 10 chance that the EUR may move more than 5 percent in either direction over a 4-week period[2].

Solution

An FX forward is a contractual obligation to exchange one currency for another at a pre-determined fixed rate and a specific date in the future.

Purchase contract

The fund sells the portfolio company for €50.0M to exit their investment. This translates to $57.5M according to the spot rate on the day the portfolio company was sold. Funds will be repatriated in 3 to 4 weeks.

Trade details

EUR/USD spot reference: 1.1500
Direction: Buy EUR/Sell USD
Notional: €50.0M
Contract rate: 1.1530
USD equivalent: $57.65M
Tenor: 4 weeks

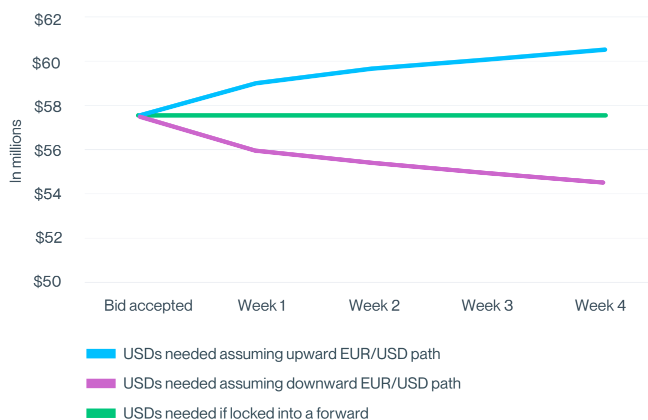
Notes: Conservative (longer) tenors are advisable as it is better to draw down the trade early than having to roll it forward, as the latter involves a cash event. The contract rate for selling EUR forward is more favorable than the prevailing spot rate, resulting in a $150,000 benefit when the USD is received. The pricing of FX forward contracts is derived from three market factors: 1) spot exchange rates, 2) interbank interest rate differentials, and 3) cross-currency basis swap rates. For EUR/USD forwards, because US interest rates are higher than EU interest rates (net of cross currency basis), the hedger receives a slightly more advantageous rate for selling euro forward versus spot.

Scenario analysis

The total USDs that will ultimately be repatriated can change materially over a 4-week period.

According to an objective probabilistic framework, there is a 10 percent chance that on a €50.0M price tag, the price can change by more than $3.0M in either direction over a four week period.

However, regardless of where the EUR/USD exchange rate should be trading on expiry date, according to the terms of the forward contract, the Fund will be selling €50.0M in exchange for $57.65M for the exit.



Source: Bloomberg, analytics - SVB FX Risk Advisory, for illustrative purposes only, December 2022

Additional considerations

- A forward contract represents an obligation to buy or sell currency at a predetermined price. Should the deal fail to materialize, the Fund would need to cash-settle the forward hedge to fulfill the obligation, resulting in a gain or loss depending on spot movements during the hedge period
- In the event the deal were to close earlier than expected, forwards may be unwound early without penalty. As a result of the early unwind, the Fund would not be exposed to potential losses from movements in spot rates since trade inception, as the position is hedged. However, movements in the forward curve, which are less material over short horizons, may introduce residual gains or losses[3]
- A delay in the expected deal close date can be handled by rolling the forward for an additional week, month, etc. as required. A "roll" is a standard FX contract, which requires cash settlement
- An FX credit line or collateral posting is required to execute forwards. These are small for short-dated tenors

If you'd like to discuss your specific situation or for information regarding SVB's tailored FX risk management services, reach out to your SVB FX contact or send an email to GroupFXRiskAdvisory@svb.com

1 Assumes a long-term average implied volatility, IV, for the EUR/USD exchange rate of 11.5%.
2 Projected loss determined by IVT x SQRT(T) x Z(.95), IV is implied volatility, T is years and Z is from standard normal such that P(Z<z).
3 Past performance is not a guarantee of future outcomes.

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