

# Market dislocation risk drives deal-contingent hedge demand

Paul Golden June 13, 2024

**The recent resurgence in M&A activity has driven interest in deal-contingent hedging as firms look for a buffer against unfavourable FX or interest-rate movements.**

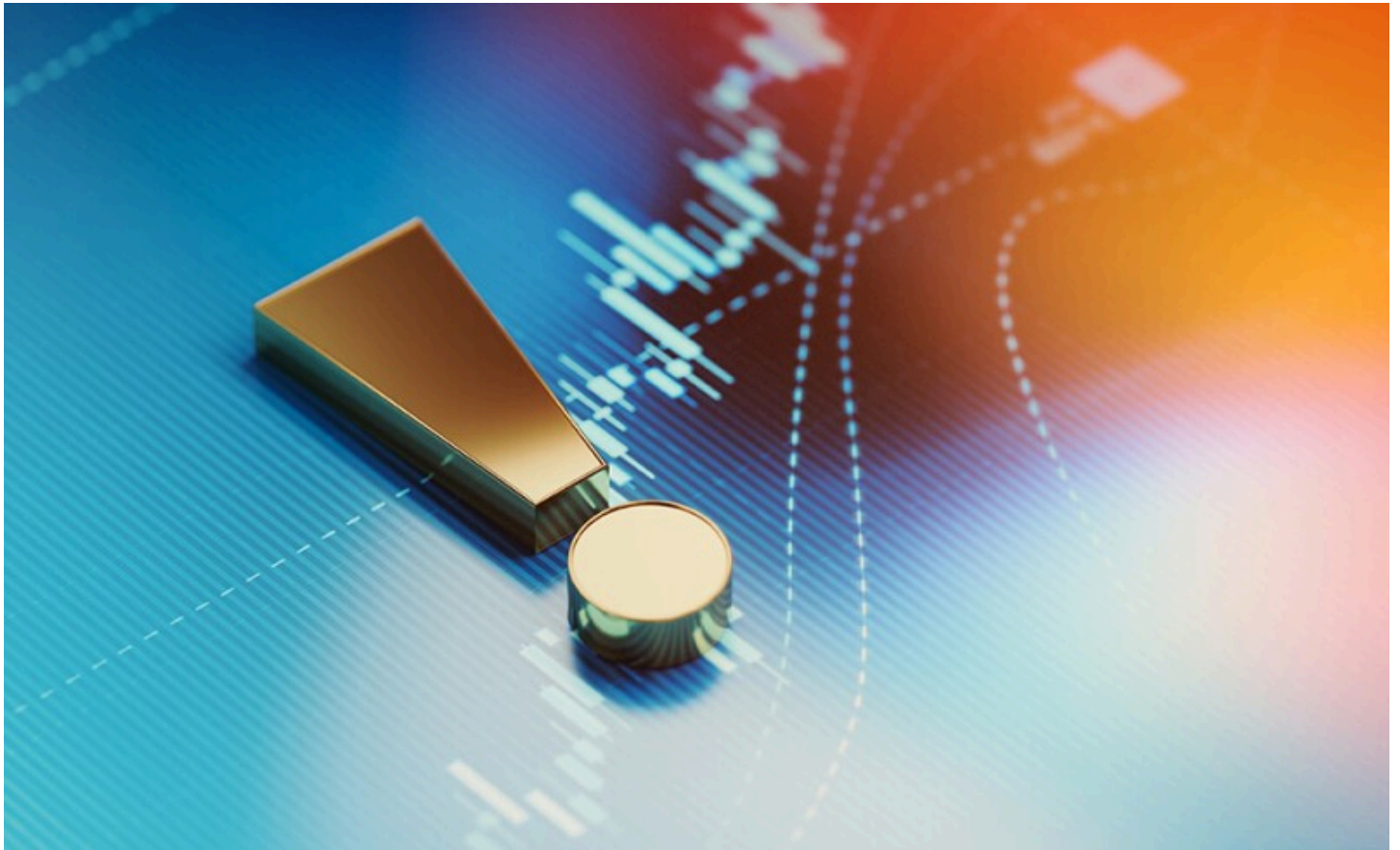


Illustration: iStock

Deal-contingent hedging (linking the settlement of a vanilla hedging instrument to the success or failure of the underlying transaction) has evolved from an efficient way of mitigating foreign-exchange risk between the signing and closing of a cross-border M&A transaction into an option for hedging interest-rate, inflation and even commodities risk.

Transactions where a market dislocation could endanger the liquidity of the company or negatively affect the economics of the underlying transaction are simply too risky to be left unhedged.

For highly leveraged project-finance deals, even a relatively minor increase in interest rates during the period prior to financial close could have a wide impact on both the debt quantum required and the eventual equity return.



Daniel Jack, Monex Europe

The appeal of the deal-contingent hedge is that if the deal fails to complete, the hedge falls away at no cost to either party.

“Deal-contingent hedging is typically used in complex deals where there are other factors such as regulatory approval and multiple lenders, as well as financing risk relating to changes in interest rates,” says Daniel Jack, head of institutional at Monex Europe.

According to S&P Global Market Intelligence's first-quarter global M&A and equity offerings report, the value of global M&A deals was 18.5% higher than the same period last year, while the number of \$10 billion-plus transactions was at its highest level since the second quarter of 2022.

“We are expecting more M&A deal activity over the rest of this year, especially in the mid-market space,” observes Abhishek Sachdev, founder Vedanta Hedging. “Our private-equity clients are about 20% more active in the first half of 2024 than they were in the same period last year. Political gyrations will affect FX markets, and there is also divergence between the eurozone, UK and US in terms of core price inflation.”

Francesco Podestà, head of interest rates at risk-management consultancy firm Audere Solutions, refers to strong interest in Europe from foreign investors, especially those from North America, and suggests FX will be the primary risk hedged.

“Interest rates had their moment with uncertainty around inflation and rising monetary policy, but that isn’t a key topic anymore,” reckons Podestà, although GTreasury's VP of risk solutions, Sandra Koch, says there is still demand for cover for interest-rate exposure.

Deal-contingent hedging on the back of M&A trades is a lot more frequent when private-equity firms are the buyers and it is a leveraged transaction, observes Federico Bellanti, independent markets specialist and founder of Milan-based Studio Bellanti.

“M&A between corporates provides less frequent opportunities for this type of hedging,” he says. “If you are a European company intending to buy a US asset, the FX rate you enter into for the purchase is less of an issue. You may pay more due to a higher price of the dollar, but you then hold on a long-term basis an asset that will generate returns in dollars.”

Bellanti agrees that the potential for interest rate-hedging should not be underestimated.

“I see increased adoption of deal-contingent hedging for interest rates in project financing,” he says. “The Middle East – with a large pipeline of financing trades of this type – should offer enormous opportunities.”

Scott Bilter, principal of AtlasFX, notes that interest-rate risk may be greater than FX risk in some instances.

“Contingent forward-starting interest-rate swaps to lock in known interest rates for a future date are often done to deal with potential interest-rate volatility between bridge financing before an M&A deal is approved and going to the market for debt financing after the deal is approved,” he says.



Francesco Podestà, Audere Solutions



Scott Bilter, AtlasFX

FX risk is covered by a bespoke hedge that essentially combines a forward and an option. The forward rate will be worse than a plain vanilla forward to compensate the bank for being short the optionality while not being paid an option premium since it must manage the risk of the forward disappearing if the transaction doesn't go through.

For interest-rate risk, the equivalent deal-contingent instrument is the forward-starting interest rate swap.

“This hedge is not in or out of the money based on future interest-rate conditions compared to the strike, but rather whether the deal happens or not, which is a different risk to manage,” adds Bilter. “These would also be off-market at a worse interest rate than an at-the-money swaption to compensate the bank for managing the associated deal risk with no premium received upfront.”

There are additional factors that will drive cross border M&A and therefore the need for hedging, suggests Benoit Duhil de Benaze, managing director European private equity hedging and capital markets at Chatham Financial.

“Some currencies are trading at attractive historical levels and there are markets trading at lower multiples – such as the UK, which has seen increased private market activity,” he says. “We see more interest-rate hedging due to an inverted yield curve and potentially higher-for-longer rates. With recent volatility in commodity pricing, we have also seen a pickup in deal-contingent hedging in infrastructure and energy-transition deals with exposure to certain commodities.”

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