

Dealing with exchange rates

Currency fluctuation and M&A

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The past few years have been characterized by a number of currency events — both long- and short-term — that have significantly impacted the business world. But what has been their effects on M&A activity? Toppan Vite, in partnership with Mergermarket, discussed this trend with five industry-leading figures.

MM: This year saw one of the largest currency fluctuations as the Swiss franc was unpegged from the euro. What is the impact on M&A of these kinds of sudden currency shocks?

TZ: Though only time will tell in the case of Switzerland, these kinds of currency shocks have several implications for M&A activity in the short-term. First, companies who hold cash in an appreciated currency have greater acquisition power with regards to foreign targets and will seek to acquire them at a discount.

This would be especially true for Swiss domestic companies, for example, that rely heavily on imports and are able to significantly reduce their expenses by purchasing foreign inputs and supplies at a lower cost. These savings will create positive cash flow, which will lead to increased M&A activity in countries with less valued currencies.

Domestic companies which rely primarily on exports, on the other hand, such as mining companies, are impacted in a different way — foreign demand for their products is reduced due to their suddenly higher prices. This decreased demand will ultimately reduce their valuation —

making them attractive to acquirers looking for a deal.

However, one obstacle to currency arbitrage is the lag time from commencing a deal to when cash exchanges hands. Since M&A can take weeks or months, the market may have already corrected the currency difference by the time money is to be exchanged, cutting most of the anticipated profits from the arbitrage. For example, although the Swiss franc jumped by 30% when it was unpegged from the euro, in about a month, it had already returned halfway to its previous levels. What looked to be a profitable deal at the time may no longer be the case when the deal finally closes.

DB: Such currency movements can clearly affect pricing in cross-border transactions. The implications will depend on where you're at in the deal process, in particular, whether you're at the auction stage, the negotiation stage or post signing. It will also depend on which side of the currency movement you are on.

A significant adverse currency movement can materially affect a buyer both in terms of the price it pays and the expected return on its investment. A buyer can seek to protect itself contractually from adverse currency movements, such as through a material adverse change clause, but often times currency movements are specifically carved out of the definition of material adverse change, making it difficult for a buyer to walk away. A buyer can also separately seek to hedge some or all of its currency exposure.

JJ: It's important to remember that a strong currency implies a demand for goods in that country, as well as strong foreign investment. It also, however, makes that currency seem relatively expensive. In the US, for example, a strong economy and increasing demand has driven up the currency. And those with expensive currencies are likely to go on and be good acquirers. As Trevor says, in terms of the type

of sudden event that Switzerland was on the end of, for Swiss companies this means that buying foreign companies has suddenly become a lot cheaper. Companies in this situation may also want to hedge the downside of having a strong currency by buying abroad. So there's a number of Swiss sectors undoubtedly now looking to buy as a result of currency change. You'll see more outbound Swiss activity due to their currency strength.

For Swiss targets, the Swiss stock market actually fell after the shock, as stocks there became more expensive for foreign buyers.

SS: The origin of the peg was very specific to Swiss concerns in my view — originally it was about worries related to currency strength during the financial crisis. I would prefer the free market to set exchange rates.

Thinking about long-term M&A considerations, you have to think about the effect it has on big pharmaceutical companies based out in Switzerland. These big firms need to manage revenue and earnings. So when they have a target in mind that isn't producing revenue but has a drug in the pipeline, it gives them time to plan and hedge against currency risk. However, with a revenue-generating firm near-term changes in currency exposure may impact the view of the products.

MAH: Firstly, the initial impact from a significant currency movement will, in whichever market that happens in, cause concern given the aversion to volatility. When things are fluid people can lose confidence, which can affect their desire to do M&A. However, when you look at mid- and long-term considerations, these kind of events shouldn't dissuade dealmakers in a big way. Whether you acquire or not is not based on whether a currency is cheap — although that can be an advantage. It's whether the acquisition fits in with your strategy that matters.

“The dollar’s rise is due to the US’s increasing attractiveness in comparison with the rest of the world.”

**Jeremy Josse, Managing Director,
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MM: Conversely, the euro has been steadily falling in value for a year, while the dollar has become stronger over the same period of time. What are the implications for M&A activity on long-term trends such as these?

TZ: Long-term trends provide the certainty needed for M&A to thrive. We can expect to see more deals involving American acquirers and European targets this year. American companies hoping to snatch a good deal in Europe will find confidence in the direction that the currencies are moving, as they are likely to find themselves getting an even better deal than what they negotiated when the deal finally closes.

DB: It’s true that the euro’s fall relative to the dollar makes assets priced in euros much more attractive. On the other hand, you’re buying a business and a buyer needs to consider what a devaluing currency means for the business. What drives the business’ fundamentals? Will its performance be adversely affected (or improved) by the devaluation? Also, if the business’ accounts are denominated in euros, you have to bear in mind that the business’ contribution to the buyer’s earnings may be lessened.

JJ: The dollar’s rise is due to the US’s increasing attractiveness in comparison with the rest of the world. Now, you’ve got US buyers looking to exploit that currency arbitrage. According to Thomson Reuters, 40% of acquisitions in Europe so far this year has been by US companies – this is double the percentage for the same period last year. This shows how a strong currency can influence buyers.

MAH: Longer-term currency trends can make areas that are subject to currency changes more attractive M&A destinations. For instance, the strength of the dollar means that it could be a good time for US companies to buy using their newly strengthened currency, as mentioned.

However, the main issue is what's underneath the currency movement. You have to think of the reasons why a currency is rising or declining and it is usually tied to the outlook for growth. Obviously we've seen currency trends in Europe and Brazil that, as we've mentioned, are being affected by concerns over future economic growth. These areas may be cheaper, but you have to ask what the underlying problem is, and whether it affects your deal rationale. Obviously there are also sector-specific considerations to think of, but long-term the strategic rationale for the deal is always the key.

SS: For the firms we look after, the rates at the moment make European biotech companies more attractive. They are less followed than their equivalents in the US, and now they will be a lot cheaper. This is attractive for US buyers with their strong currency.

Anecdotally we've also seen European biotech coming over to the US market. There seems to be a realization that with this long-term trend, it might make sense for them to look for US partners or US investors. Yet, at the heart of it, away from currency changes, it's the state of the company and quality of its science/technology that will determine activity.

MM: Which regions present the best M&A opportunities given the current differences in currency strength?

TZ: Europe has already been mentioned. The euro has continued to trend downward over the last year, reaching 12-year lows against the US dollar, sinking closer to parity.

Latin America also springs to mind. Countries there have generally seen their currencies falling relative to the US dollar and this is forecasted to continue in the upcoming years. The Brazilian currency, the real, has recently fallen to its lowest point in 10 years compared with the US dollar.

28%
appreciation of Swiss franc
on the day it was unpegged
from euro

Source:
Thomson
Reuters

8.7%
fall in Switzerland's main share
index on day of unpegging,
amounting to roughly a
US\$100bn market value loss

Canada is another country that continues to present great M&A opportunities for foreign investors. First, the Canadian dollar has fallen to its lowest point in 10 years compared to the US dollar, due in part to sinking oil prices and the Bank of Canada's dovish monetary policy. Analysts predict that the Canadian dollar will stay depressed for at least the next two years. Foreign investors — especially US-based investors — are well positioned to benefit from this situation as the currency spread creates purchasing power, which can be used in a market where the valuations of a number of Canadian energy and mining companies with strong fundamentals have decreased.

DB: You have to remember that currency movements are a double-edged sword. As Trevor says, in Brazil, the real has tumbled. Assets that may have looked expensive to potential buyers previously are now starting to look attractive.



But as I mentioned before, prospective buyers have to look at the factors that have caused the currency to tumble. And in Brazil's case, you see a lot of political and economic destabilization. It's a similar case for assets in the eurozone, in particular Greece.

JJ: You can exploit a strong currency by looking at regions, but as David says, if one is seeing a currency decline, it can be a double-edged sword. Buyers really want to be looking for good companies that have been taken down a bit by the currency, and that's what they should focus on. Although it is true if the currency falls through the floor then investors will start to get spooked off.

If you take Europe, the economy is slowly recovering, the region has legal stability and fiscal attractiveness. All of these, along with the euro's fall, are good reasons to buy in Europe. The Baltic States are a good example. These countries and their economies are performing well – but having recently joined the euro, they have seen the prices of their assets fall. For instance, if you take Lithuania as an example, they are going through something of a golden age. So if you have a strong currency, why not invest in somewhere like that and potentially pick up a good deal?

Places such as Latin America are slightly different stories. The devaluation is there, but you have to look at what's underneath that – and quite a bit of that is down to political and economic instability. Yet it isn't all like that – in Colombia, for instance, the peso has dropped in value but the country is performing well. The key is that this is a macro issue – but you can't ignore the micro.

SS: As mentioned, there is a general feeling that European stocks are undervalued when compared with the US. In addition, economic strengths in the Anglo/Northern Europe countries makes for attractive initial roll-out markets. Ultimately, however, pre-revenue companies are bought based on pipeline, so I wouldn't say currency is the biggest driver there.

MAH: US companies, given the currency, should be looking towards Europe. Last year we found it slightly puzzling that we didn't see more European activity in the US when the euro was stronger, particularly as the US was and is a relatively stronger growth environment. Looking longer-term in Europe, there will be strength as a whole in the coming years. This should be spurring companies, particularly from the US, to take action now and not miss out on opportunities.

MM: How can companies and sponsors mitigate against foreign exchange risk and currency changes given the prolonged amount of time needed for the deal process?

TZ: There are a few ways to address foreign exchange risk during the pre-acquisition phase. First, if exchange rates are satisfactory at their current level, companies can lock in the rates by entering into foreign currency forward contracts. These contracts are a binding commitment to exchange currencies at the specified rate, which allows companies to enter into deals with certainty that the price they negotiated will be the price they're paying. That said, under such forward contracts, companies are bound to exchange currency regardless of whether or not the deal closes. If companies wish to avoid this risk, they can enter into deal-contingent derivative contracts, which are cancelled if the deal fails to close. However, these contracts may be expensive. Alternatively, companies can purchase foreign currency options. These options give companies the right, but not the obligation, to purchase currency at a specific rate, in exchange for paying a premium to the broker. As such, they allow purchasers to participate in any favorable movements of the currency without taking on the downside.

DB: There are many solutions for those exposed to currency fluctuations. The easiest way to do this

is to hedge your exposure. As an example, one of our client's funding currency wasn't USD, while the target's was. The exchange rate was moving in the wrong direction from our client's perspective. To protect themselves, they ended up hedging their position.

In addition, as I mentioned before, you also can try to construct contractual provisions to protect yourself from adverse currency fluctuations.

JJ: There are several ways to do this. One of the standard methods is using derivative instruments, where, in the face of currency fluctuations, you would use futures or options to hedge against them. This is tried and tested. You can also have contingent forward contracts that Trevor mentioned. Away from this, it's also worth talking about diversifying risk, especially if you are a big company. It's important to think about your global exposure if these sorts of currency fluctuations occur. And if a certain country is particularly volatile, you might want to reduce your exposure.

MAH: In the near-term, one thing acquirers are concerned about is sharp currency swings that can occur between signing and closing. Derivatives can help in this area, and indeed straight after the Swiss franc unpegging we saw a peak of interest in those.

Managing the longer-term currency risks that happen post closing, can be more difficult. One tool is using local financing. You can look to get euro-denominated debt, for instance, if you are a foreign acquirer buying a European asset.

Natural hedging is about matching the currency of your expenses to your revenue flows. With bigger targets, managing this currency risk is easier as even though they may be based in one country, they can be global businesses with revenues and expenses coming in from outside their domestic markets. For smaller or middle sized targets, which often only have a purely domestic business, this can be difficult.

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**Trevor Zeyl, Associate,
Norton Rose Fulbright**

MM: With currency fluctuations, is it better to use cash or equity as currency for M&A transactions?

TZ: It depends. If one's currency appreciates and all else being equal, cash will get you a better deal for outbound M&A. You will also need to consider the prevailing interest rate. If interest rates are low, you might get a better return on investing your cash for an acquisition rather than diluting the company's equity.

You should also consider how the market values your company. Currency shocks can impact the market as a whole, as we've seen in Switzerland. While an efficient market will, in most cases, correct your stock to its true value long before you are able to close an M&A transaction, in some cases this market volatility may cause your company to be over or undervalued. If you have reason to believe your company is undervalued, it would be better to use cash rather than equity, otherwise you might be paying more than you intended.

JJ: Currency fluctuation isn't really a main driver of whether you use stock or cash. A lot of it is based around company specific factors such as the buyer's cost of cash/debt versus its cost of equity.

Having said that, currencies can come into play in certain situations. For instance, as I said, when the Swiss franc shot up we saw Swiss stocks fall, due to their relative expensiveness for foreign buyers. In this case, if you're receiving stock as currency in a deal, you will be nervous – obviously, this can work both ways. But overall when considering volatility, it's preferable to use cash in deals.

MAH: Using equity typically doesn't help with currency fluctuations. There's a preference for cash at the moment given its availability. Companies only really want to use equity if they have to. There can even be problems when you try to use equity in cross-border transactions. If a US acquirer pays using equity, for instance, foreign shareholders might not be able to or might not want to hold the equity of a US company. They may sell the

shares back into the market, putting pressure on the acquirer's share price. This is called flowback.

SS: When I'm looking at M&A involving big pharma, there is definitely a bias towards them using cash. Put simply, cash is so cheap nowadays, so I would say you're better off using cash for deals. Cash also gives you control over the currency hedging, as for example you can issue bonds locally.

When doing smaller deals, however, we say it's more important to look at the relative value of each company. In addition to solving for limited financial wherewithal, the parties can use equity to redomicile, a current hot topic.

MM: How do currency fluctuations impact the financing of cross-border deals?

TZ: Volatile currencies affect investor sentiment and ultimately companies' stock prices. If a company's stock price has depreciated as a result of fluctuations in currency, it is less likely that the company can rely on equity offerings to finance their cross-border deals. Conversely, if a company's stock price has increased as a result of fluctuations in currency, such company would be well advised to finance any M&A activity through equity offerings.

Currency fluctuations also impact interest rates, which play a major role as a determinant of M&A activity. Central banks take currency levels into account when setting interest rates, as they can achieve some of their monetary policy objectives, such as inducing economic activity. Companies operating in countries with low interest rates, such as Canada and Switzerland, may wish to spend their cash on M&A if doing so creates a better return than the prevailing interest rates. As well, the cost of debt financing a transaction is much cheaper.

DB: That's a difficult question. It isn't easy to use equity in cross-border deals: you can't just indiscriminately issue shares. Most jurisdictions closely

regulate securities issuances. A buyer's ability to use shares as consideration will depend on, among other things, who the sellers are. Notwithstanding the currency turmoil we have been discussing, I think cash will continue to be the preferred form of consideration.

MAH: It can bring more focus on to local borrowing and using the target's balance sheet to finance the deal. Acquirers also have to have the appropriate derivatives in place if they can't get enough local borrowing. Generally, acquirers need to think about how they are hedging their targets in an uncertain currency environment.

JJ: It depends on where the movement is. For instance, the euro's decline is a reflection of economic stagnation in the area. Finally it seems, the European Central Bank is stepping in and starting a stimulus program with quantitative easing.

One of the effects of this is that it makes euro funding cheaper – indeed, we're in a situation now where US T-bills are yielding more than German bunds. For US companies, this then means it is now sensible to fund a deal in euros rather than dollars. So far this year, US corporate debt issuance in Europe is three-times that of last year for the same period. The euro's decline and monetary easing – hitting yields – means that buyers are looking to fund in the area.

SS: Over the past couple of years, the trend has reversed. There has been an increasing focus on European companies coming to raise capital in the US. However, the driver to the US has always been the base of biotech specialty funds. More recently, US investor risk tolerance has gone up, leading to a substantial increase in IPO activity.

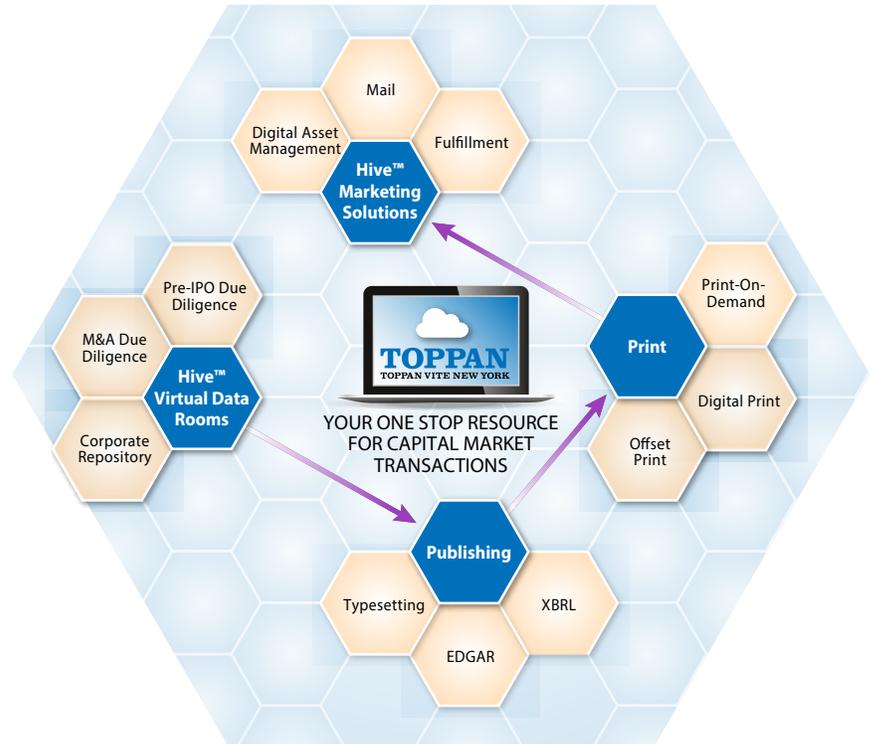
It also depends on the size of the deal. We have companies at the moment looking to list on the AIM in London as they're the right size for it. In the US, investors want a certain size deal, and if it's smaller than that they're typically not interested due to liquidity concerns. Currency has also played a part.

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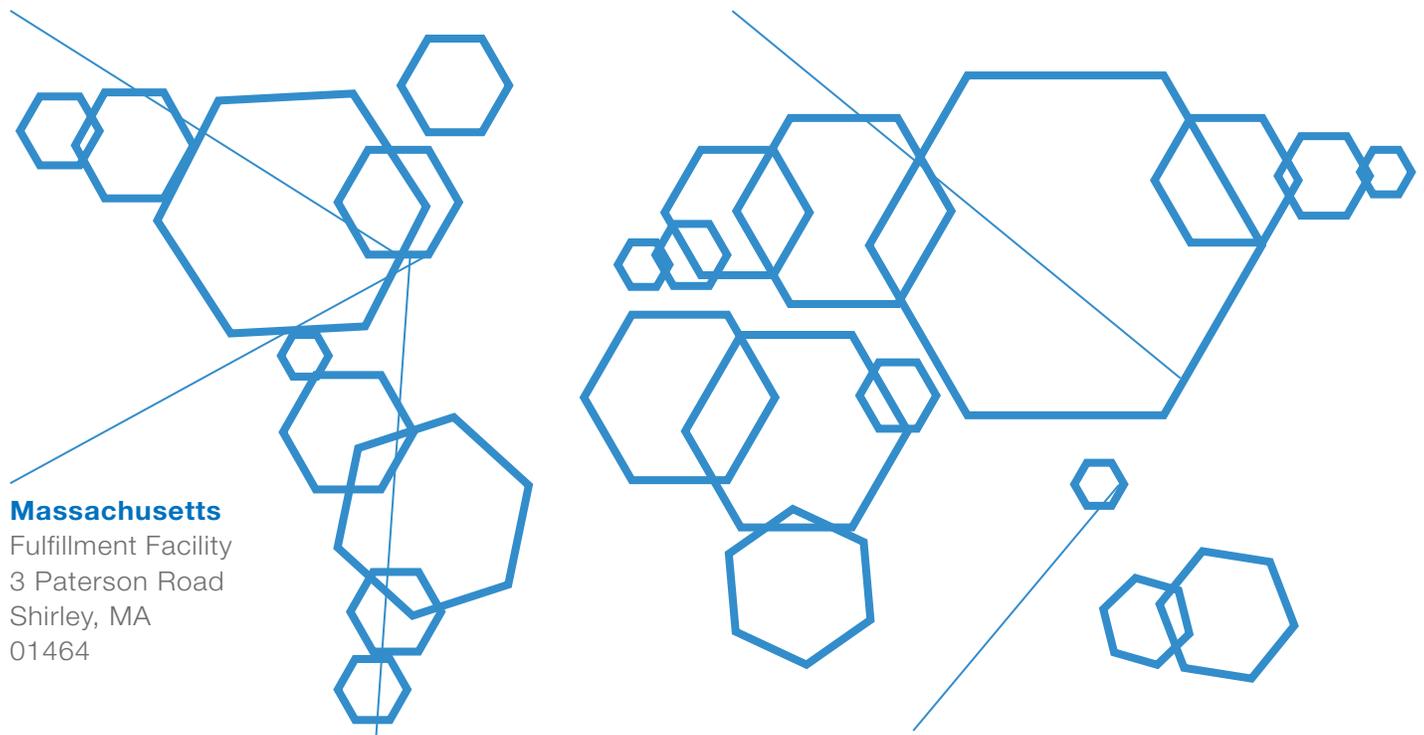
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