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Secondaries & Fund of Funds
Debt Seminar

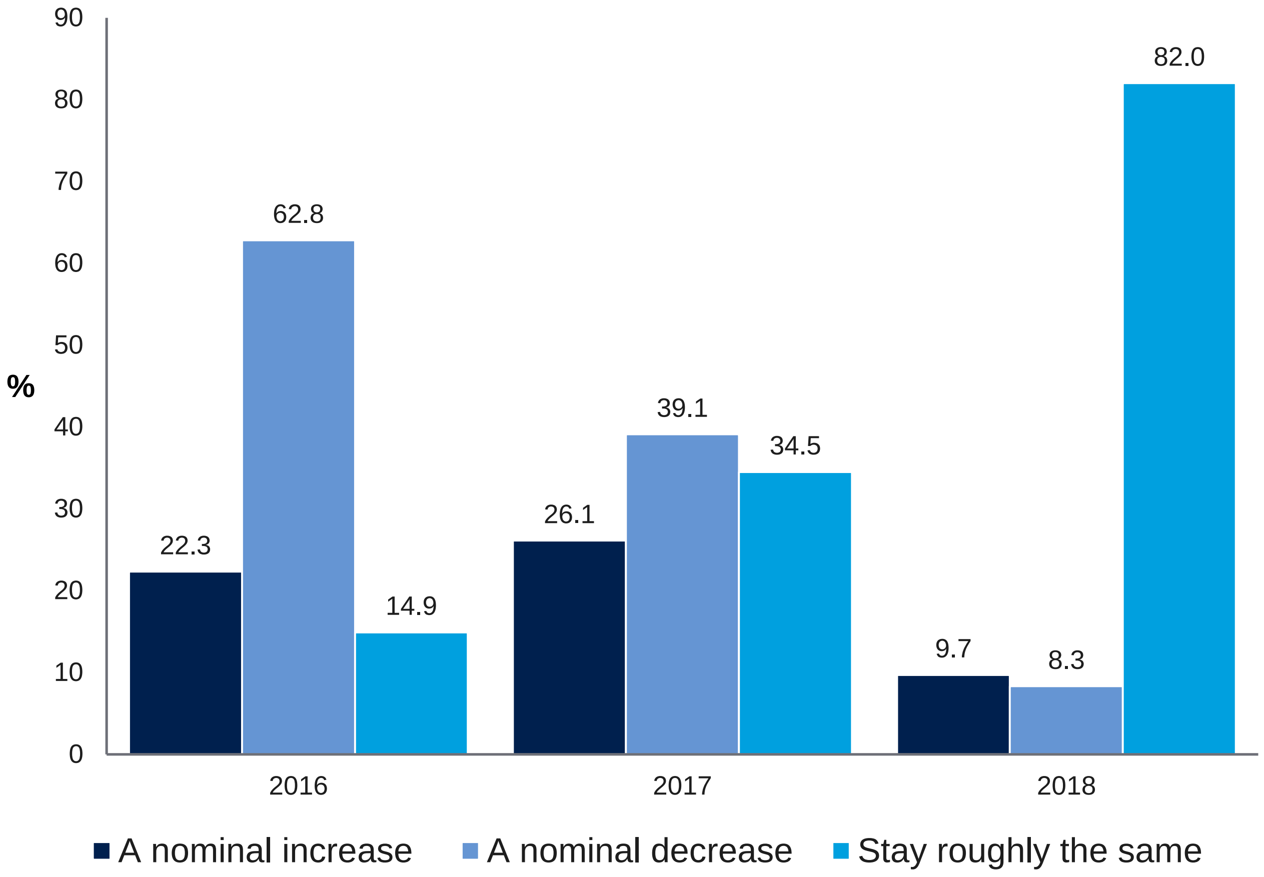
27 September 2018

Welcome & introduction

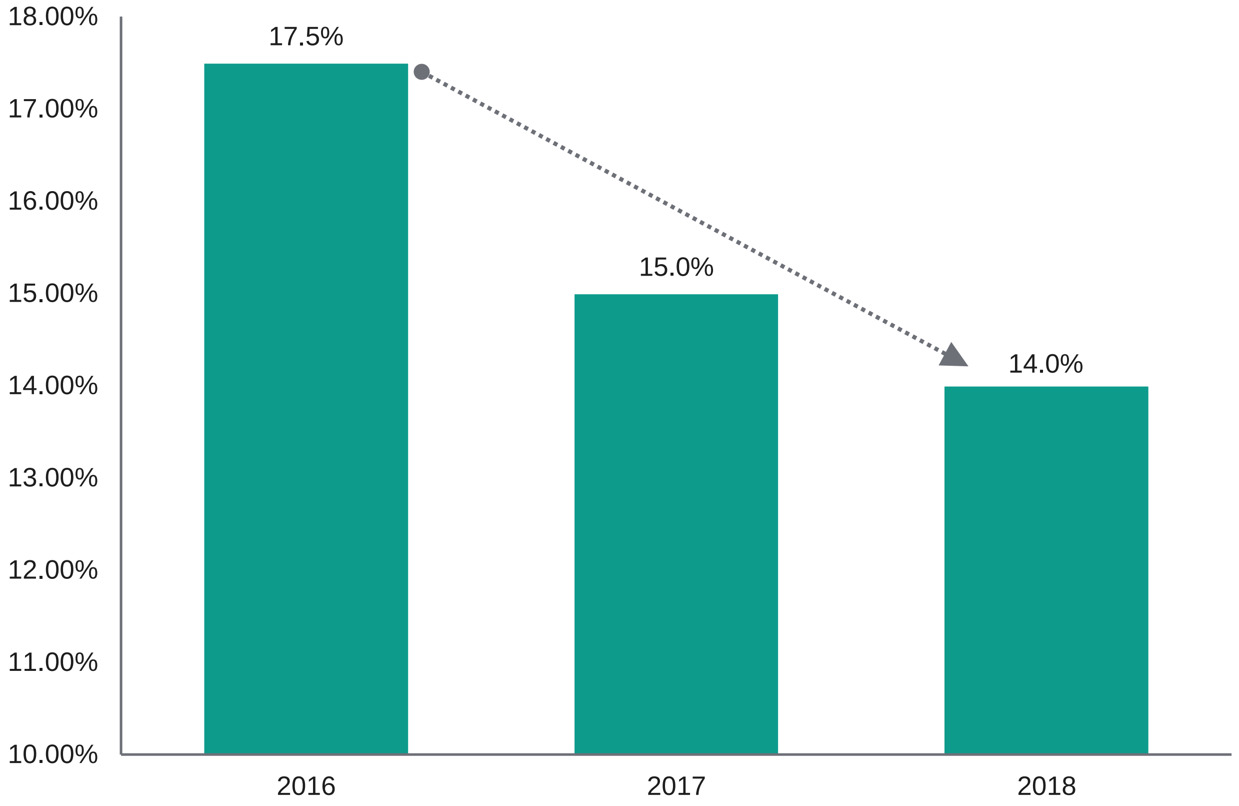
Simon Hamilton,
Investec

Pricing and returns

Pricing expectations – 82% of respondents expect pricing to stay roughly the same in the short term



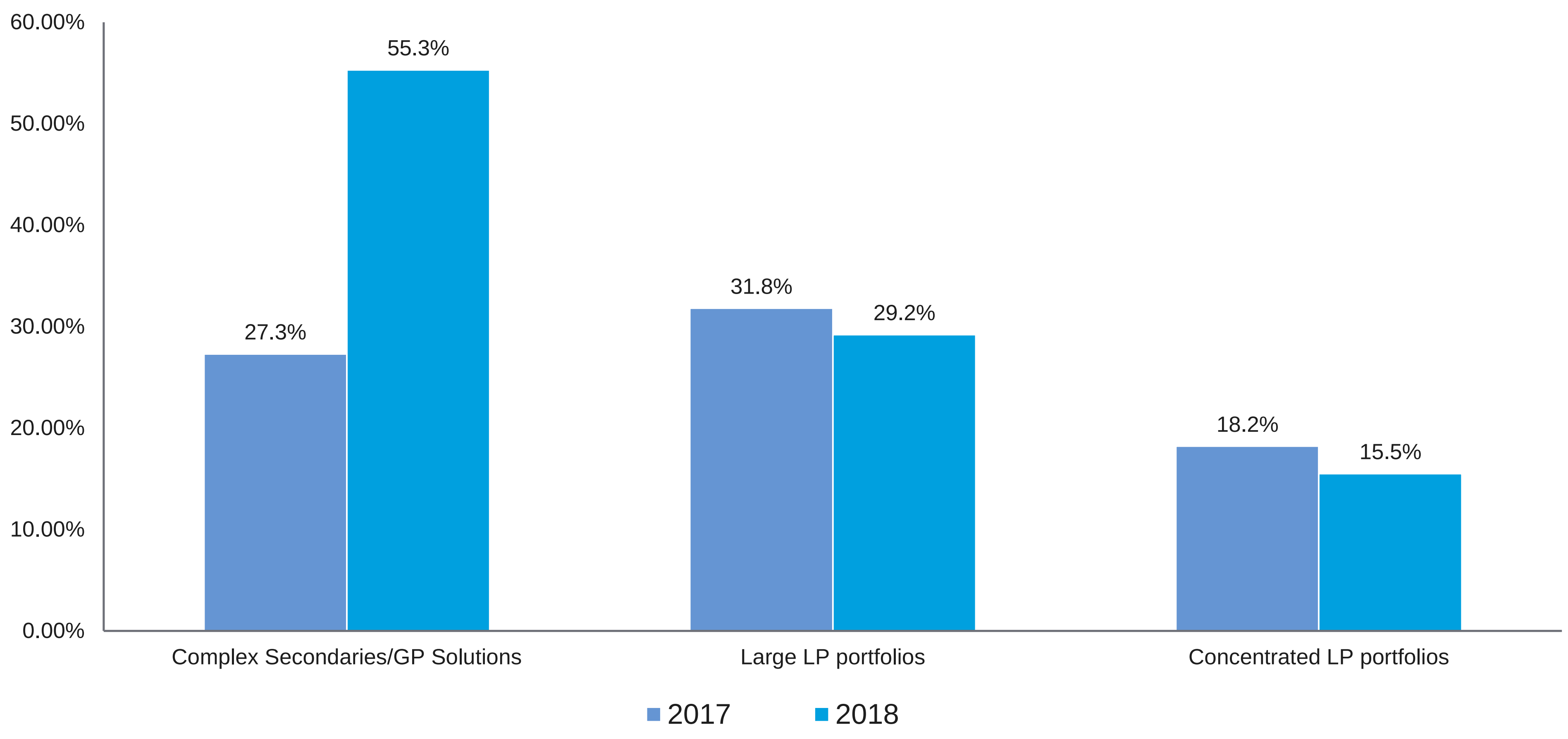
Returns expectation – slightly down



Source: Investec Secondaries & Fund of Funds pre-event survey, 2018

Where do you expect to deploy most of your capital?

Complex secondaries / GP solutions attracting more capital



This is in line with some market data suggesting that more than 35% of market value in secondary market driven by GP-led solutions.

Source: Greenhill presentation, September 2018

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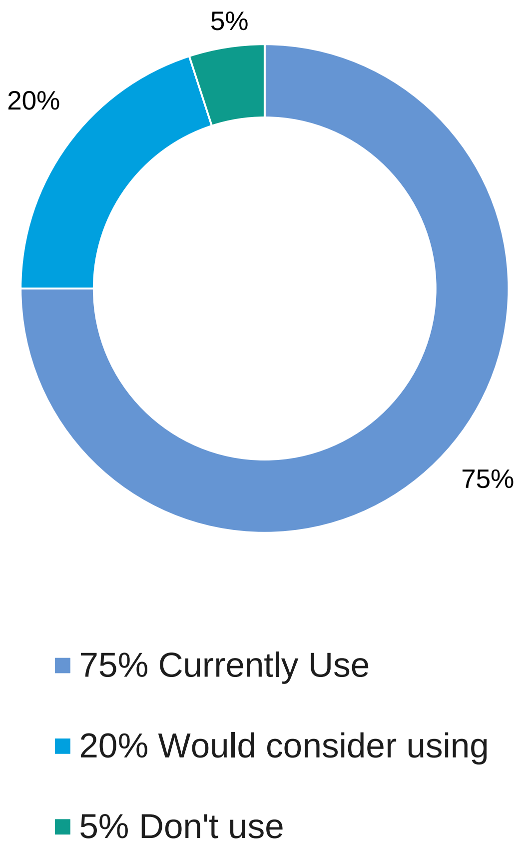
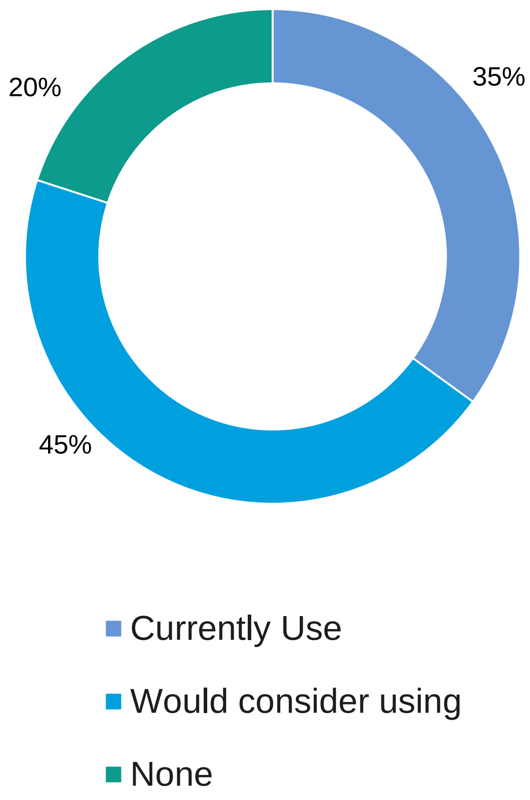
Use of funding solutions

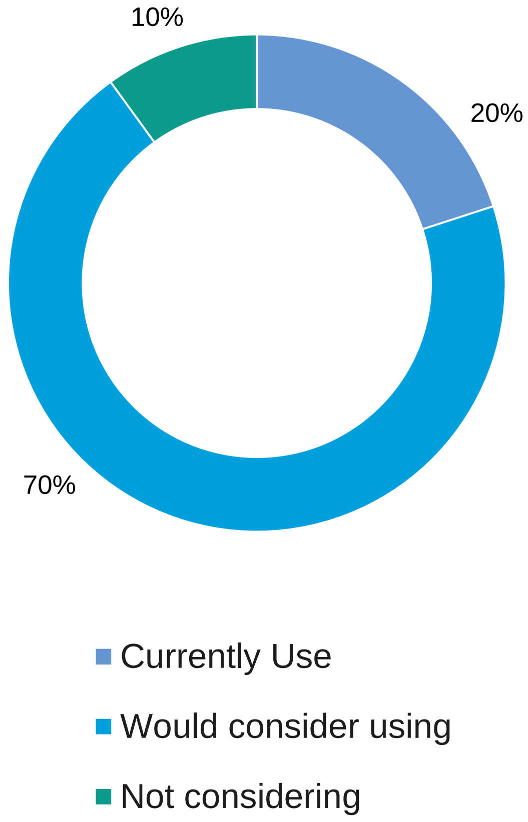
Capital call facilities



SPV asset finance



Hybrid facilities



- Capital call is now standard:
  75% (2018); 76% (2017)
- Asset backed finance is on the increase:
  35% (2018); 30% (2017)
- The popularity of Hybrid facilities has doubled YoY:
  20% (2018); 10% (2017)
- In line with last year the majority of respondents are consider using leverage for a dividend recap

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Agenda

- Market overview – Francesca Paveri Fontana, Evercore
- Multiples, Holding Periods and Other Emerging Trends – Mike Wright, Centre for Management Buy-Out Research
- Private Equity becomes tailor made – Ian Wiese, Investec
- How sophistication in the market is driving innovation – Matt Hansford, Investec
- Changing attitudes towards hedging – Joe McKenna, Investec

Networking and summer sundowners begin

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Secondary market update

Francesca Paveri Fontana,
Evercore Private Capital Advisory

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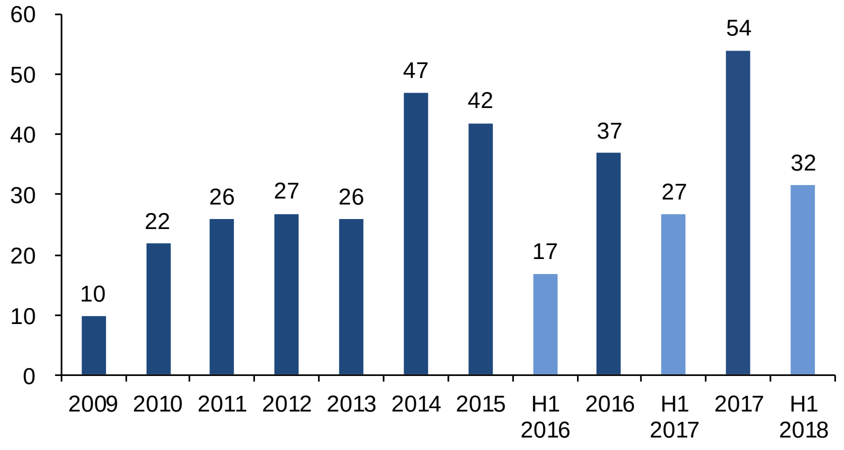
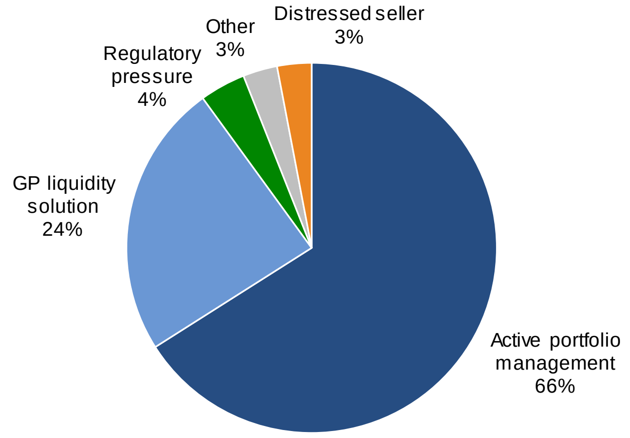
2017 & H1 2018 Snapshot

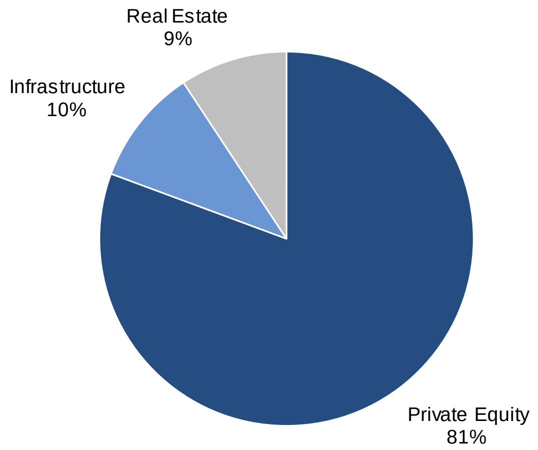
Transaction Volume Over Time (In $ billions)



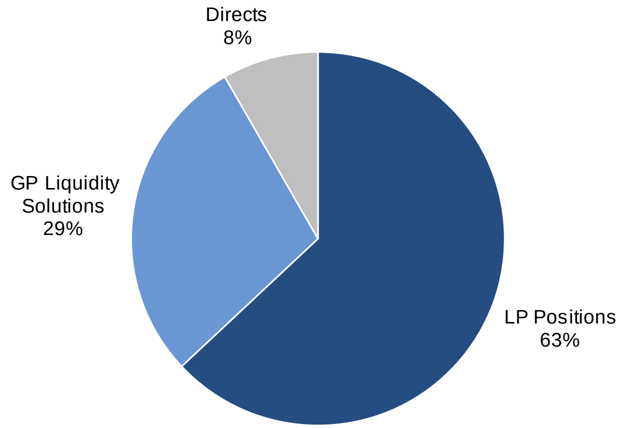
Split by Reason for Sale – 2017



Split by Asset Type – H1 2018



LP Deals vs. Direct Deals – H1 2018



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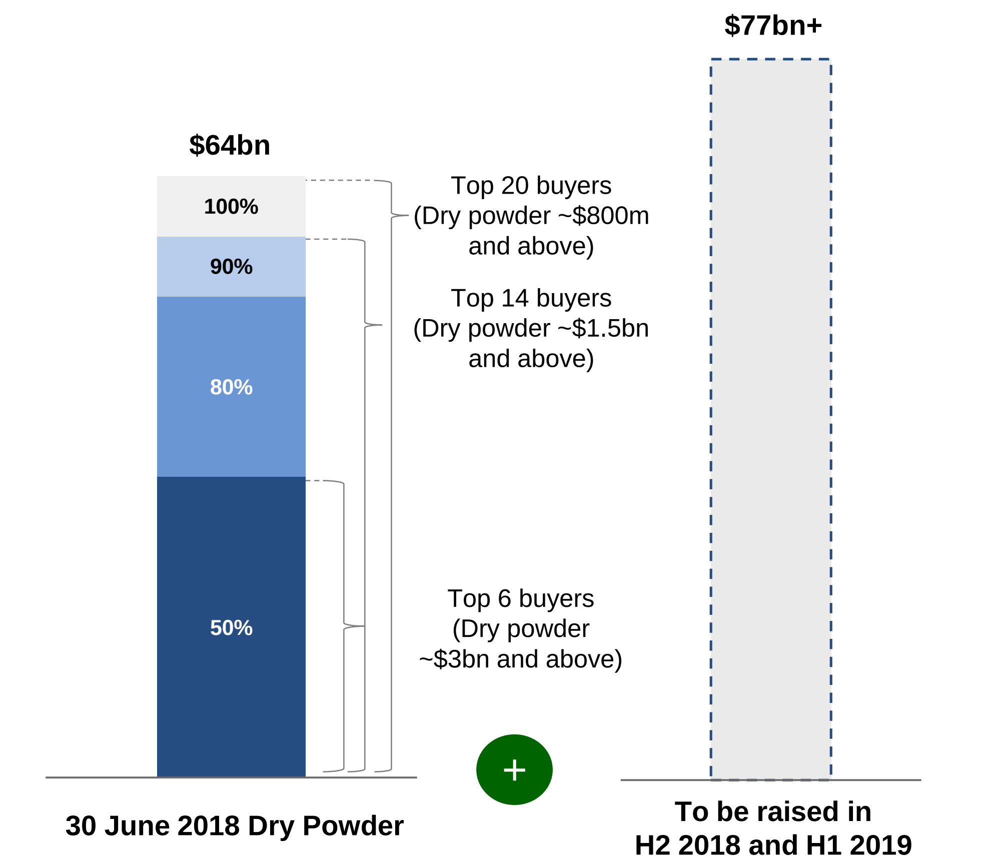
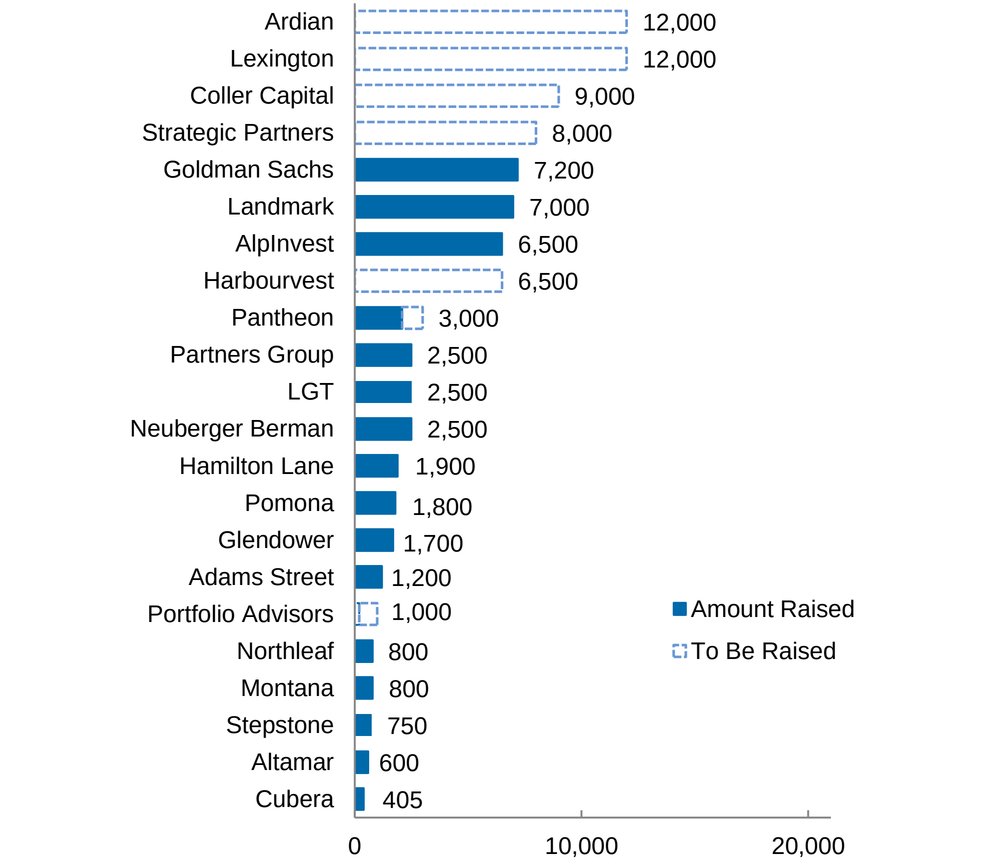
Abundance of Dry Powder & Financing…

Dry Powder as of 30 June 2018 – Concentration



Largest Secondary Funds Closed or In The Market

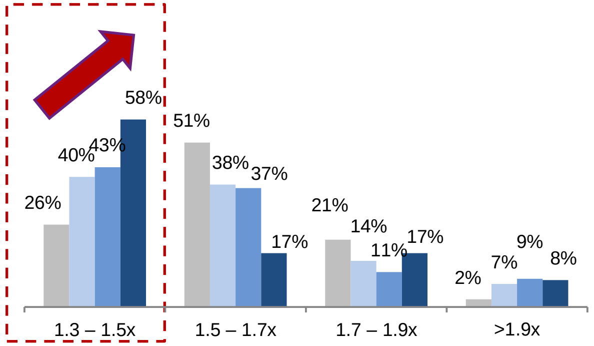


Proliferation of Leverage

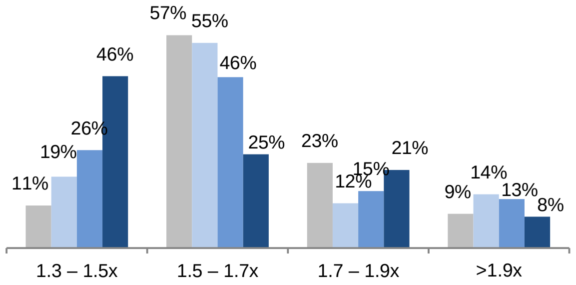
- New entrants providing financing
- 50%+ LTV
- Diversified portfolios sold to a single buyer

… Resulting in Decreasing Underwriting Criteria and Record High Pricing

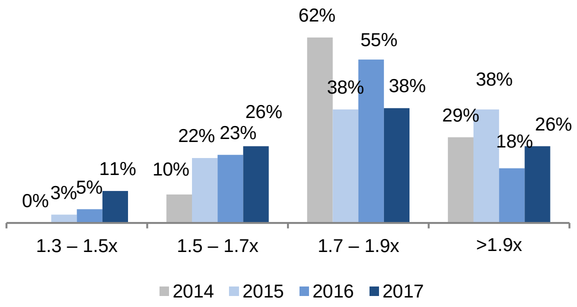
Buyer Target Returns (Gross / Pre Buyer Economics)



Good quality diversified portfolio of 25+ buyout LP positions, (4y exit horizon)

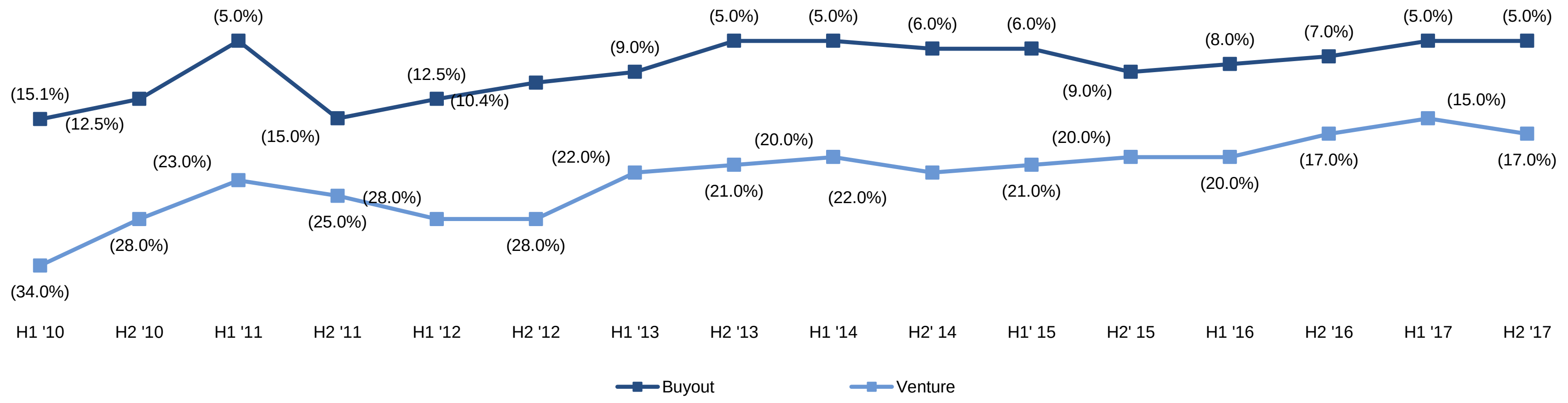


Good quality single buyout LP position (4y exit horizon)



Good quality portfolio of 5 direct assets (4y exit horizon)

Historical Average Pricing Levels (Average discount to NAV)



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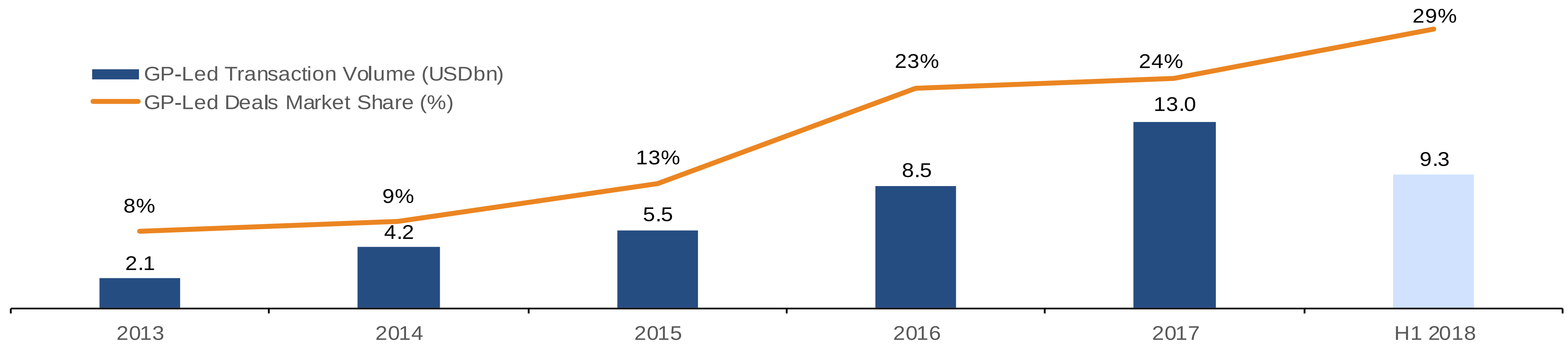
The GP–Led Market

Well Known GPs Are Increasingly Taking Advantage of the Secondary Market

GP-Led Secondary Market Volume



Historical GP-Led Deals

2015: arcus Infrastructure Partners, LBO France, First Atlantic, Palamon Capital Partners, Hutton Collins Partners LLP, PM & Partners Private Equity, Irving Place Capital, SilverLake, J.C. Flowers & Co. LLC, terra firma, KRG Capital Partners, Lee Equity, VSS

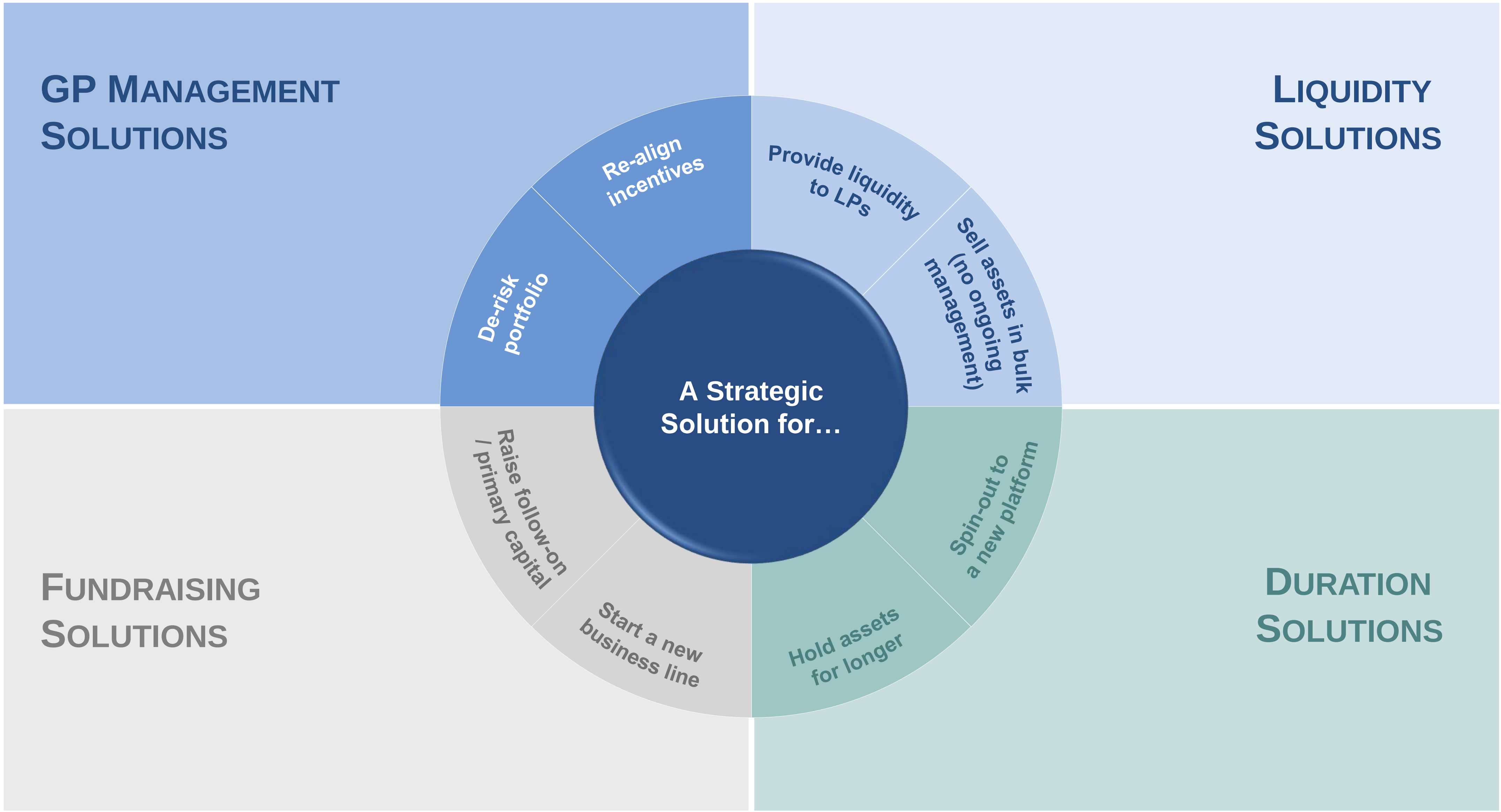
2016: Bridgepoint, CA, Eiser Infrastructure, Quadrangle, Ergon Capital Partners, TDR Capital

2017: Baring Vostok Capital Partners, Innova Capital, BC Partners, Investindustrial, Enhanced Equity Funds, Warburg Pincus, Monitor Clipper, EQT, EOS, Sheridan, Halder, Vector Capital, First Reserve Corporation, 21 Partners

2018: Doughty Hanson & Co, Lime Rock Partners, Nordic Capital, Stonepeak Infrastructure Partners, Providence Equity, TPG, PAI Partners, Warburg Pincus

1. Source: Evercore PCA Secondary Market Surveys 2014 - 2017
2. Source: Evercore Intelligence and publicly available information

The Secondary Market Can Offer a Wide Range of Solutions to General Partners



Overview of Select Typical Transaction Structures

Secondary Market Transaction Structures

LP Tender

Description

- LPs are offered option to sell or retain LP interest in the Fund
- No change to Fund's economics; ability for new investor to provide GP economics

Results

Optional Liquidity to LPs	Partially new incentives	Stapled Primary Raise

Asset Sale / Continuation Fund

Description

- All or a portion of the Fund assets sold to a NewCo; LPs offered optional rollover on substantially same economics
- New fund term and GP economics for NewCo

Results

Optional Liquidity to LPs	Term Extension	Incentive Reset	Primary / Follow-on Raise

Strip Sale

Description

- Strip of select/all Fund assets sold to new investor; LP retain exposure to upside and receive near-term liquidity
- No change to the Fund's term or GP economics; ability for new investors to provide GP economics

Results

De-risking of portfolio	Lock-in performance	Liquidity to LPs

Fund Recapitalisation

Description

- Debt/Preferred Equity raised at Fund level to be used for follow-on or issuing distribution to LPs; LPs become subordinated and can be offered co-invest in facility
- No change to existing fund terms or GP economics

Results

Liquidity to LPs	Follow-on Raise

Hot Topics Around GP-Led Deals

Rationale for the Transaction	▪ Desire to maximise the return on the assets by holding them for longer and need for additional capital ▪ Desire to de-risk the portfolio by taking money off the table ▪ Desire to offer LPs liquidity at a maximised price ▪ Desire to change the incentive structure to make sure the team working on the deals is the one properly incentivised
Term of the NewCo	▪ Can vary from 3+1+1, to a 7 year term or so
Management Fees	▪ Highly dependent on the transaction, but would typically be in the 1-1.5% range of purchase price + follow on capital
Follow-on Capital	▪ Can be raised either from just the buyer, or from buyer and rolling LPs equally ▪ Dilution mechanism to be discussed if rolling LPs are not participating in the follow-on
Carried Crystallisation	▪ Where does the fund stand in the Waterfall and is carry being crystallized as part of the transaction ▪ What proportion of the carry is being rolled in to the next structure
Carry Interest	▪ Typically tiered structure with initial hurdles being between 8-10%. A multiple hurdle can on occasion be included ▪ It is common to see carry levels above 20% for returns above 2.5-3.0x cost
LP Rollover	▪ What does the LP Rollover option look like? ▪ Is it easy for LPs to roll over? ▪ What economics are rolling LPs on? ▪ Do the rolling LPs believe in the assets long term?

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Thank you

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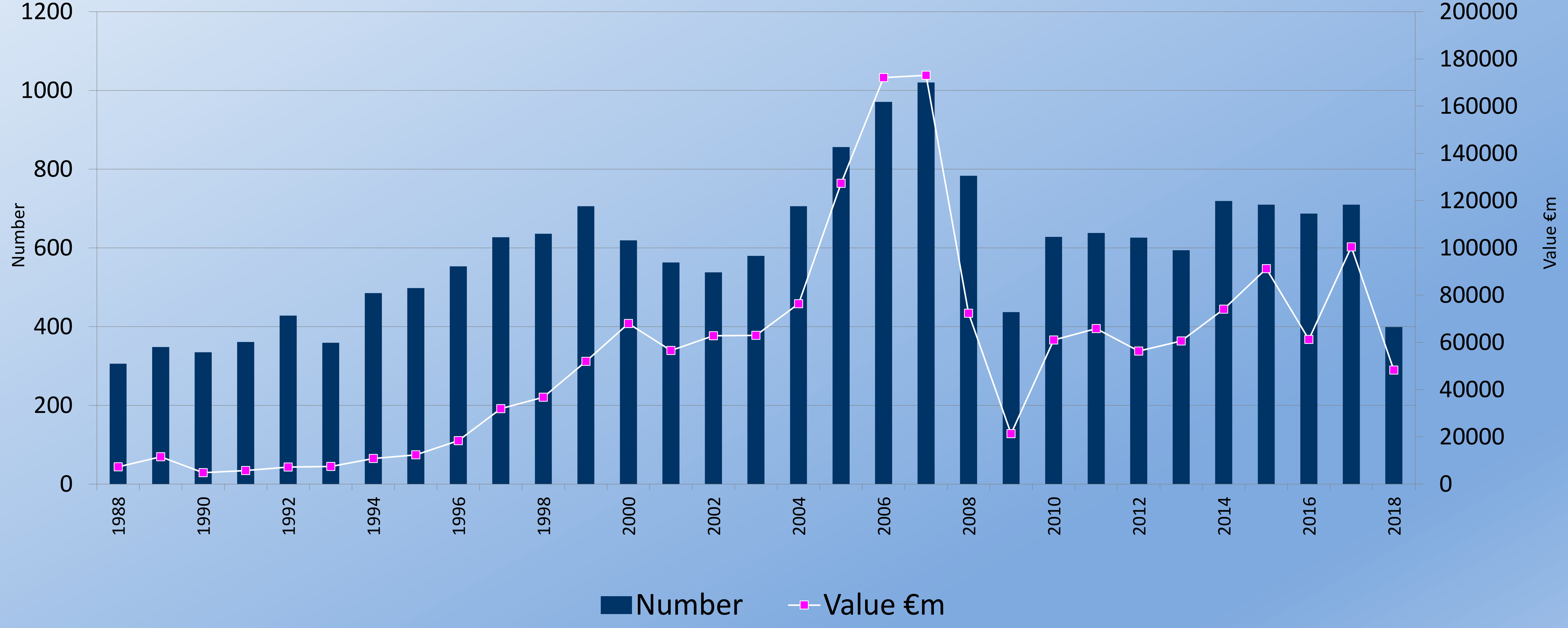
Evercore's Private Capital Advisory practice was launched by a group of industry experts in September 2013. The group seeks to provide the highest quality sell-side advice to Investors in private equity funds, real estate funds, infrastructure funds, and private credit funds seeking liquidity in the private equity secondary market as well as to general partners looking to explore GP-led transactions.

Multiples, holding periods & other emerging trends

Mike Wright,
Centre for Management
Buy-Out Research

European PE-backed buyouts best since 2007 in 2017



European PE backed exits end of cycle?

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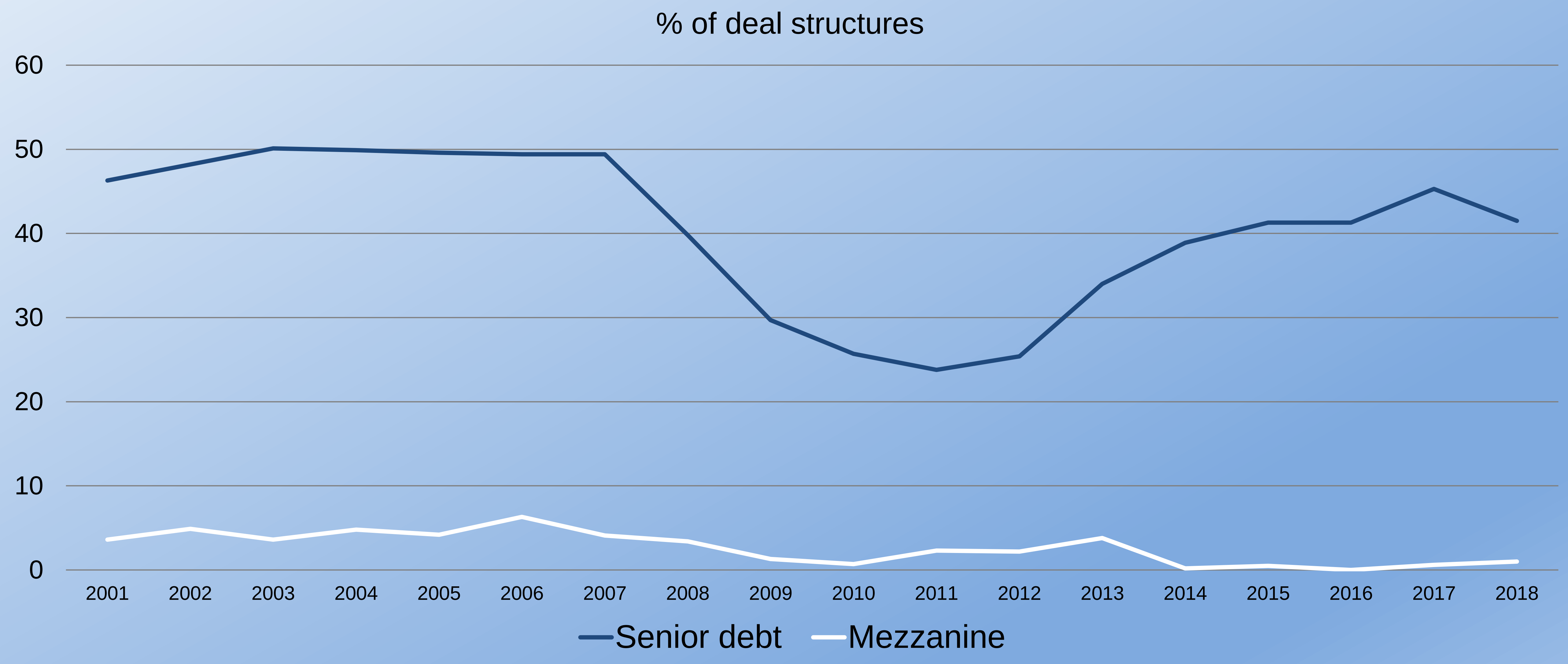
Debt availability (deal structures €10-250m)



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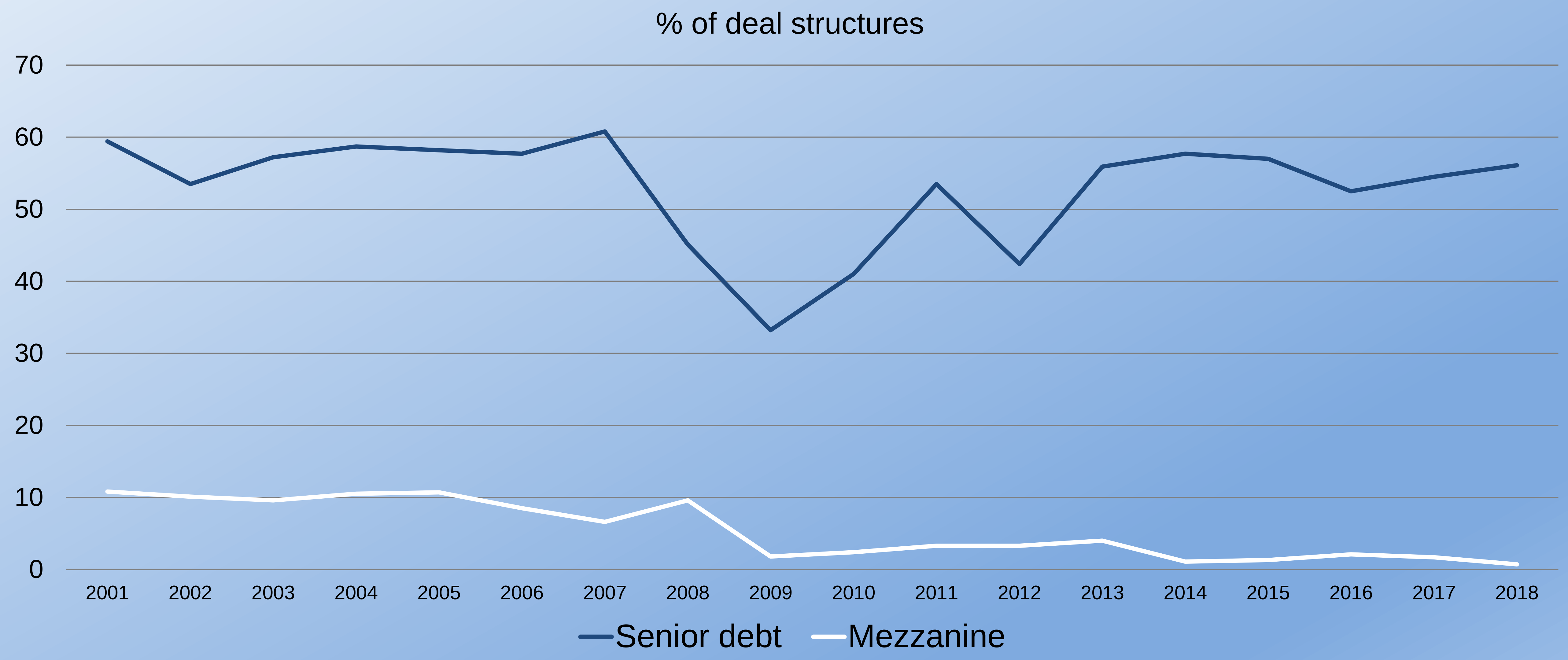
Debt availability (deal structures above €250m)



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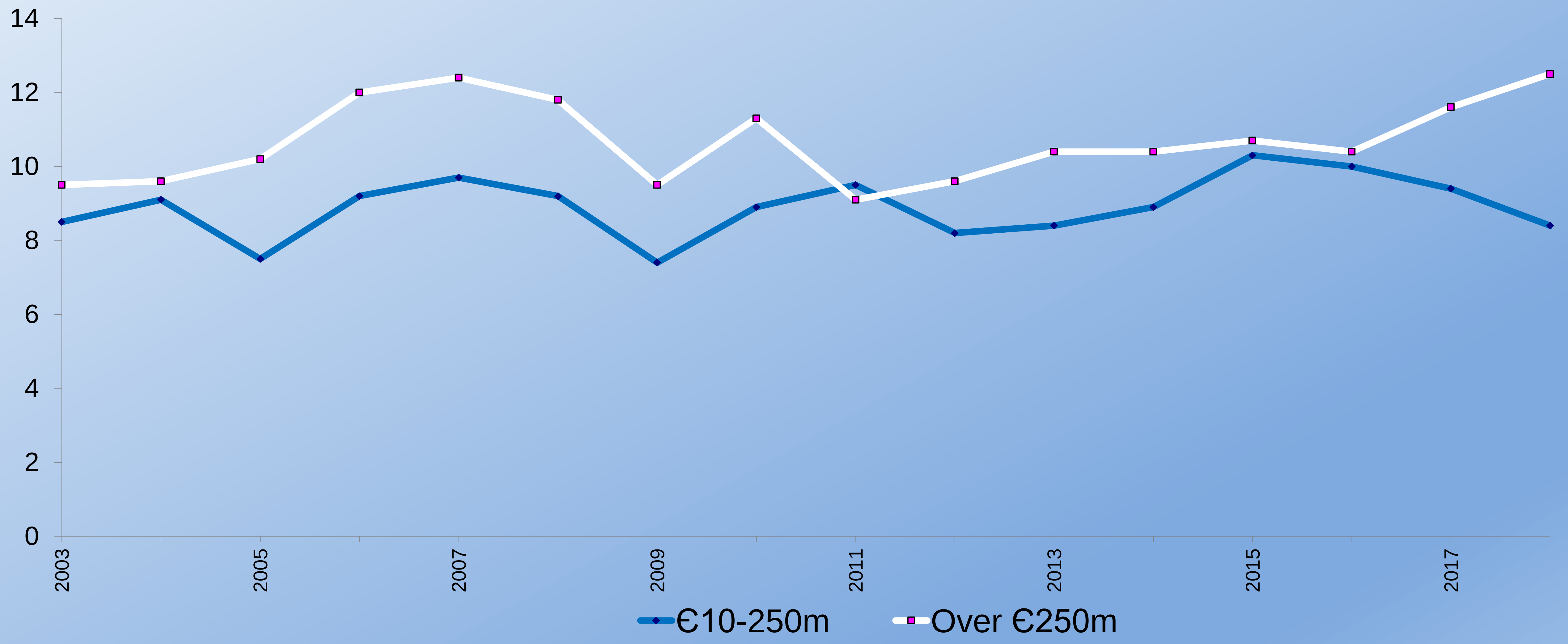
European PE-backed entry EBITDA multiples



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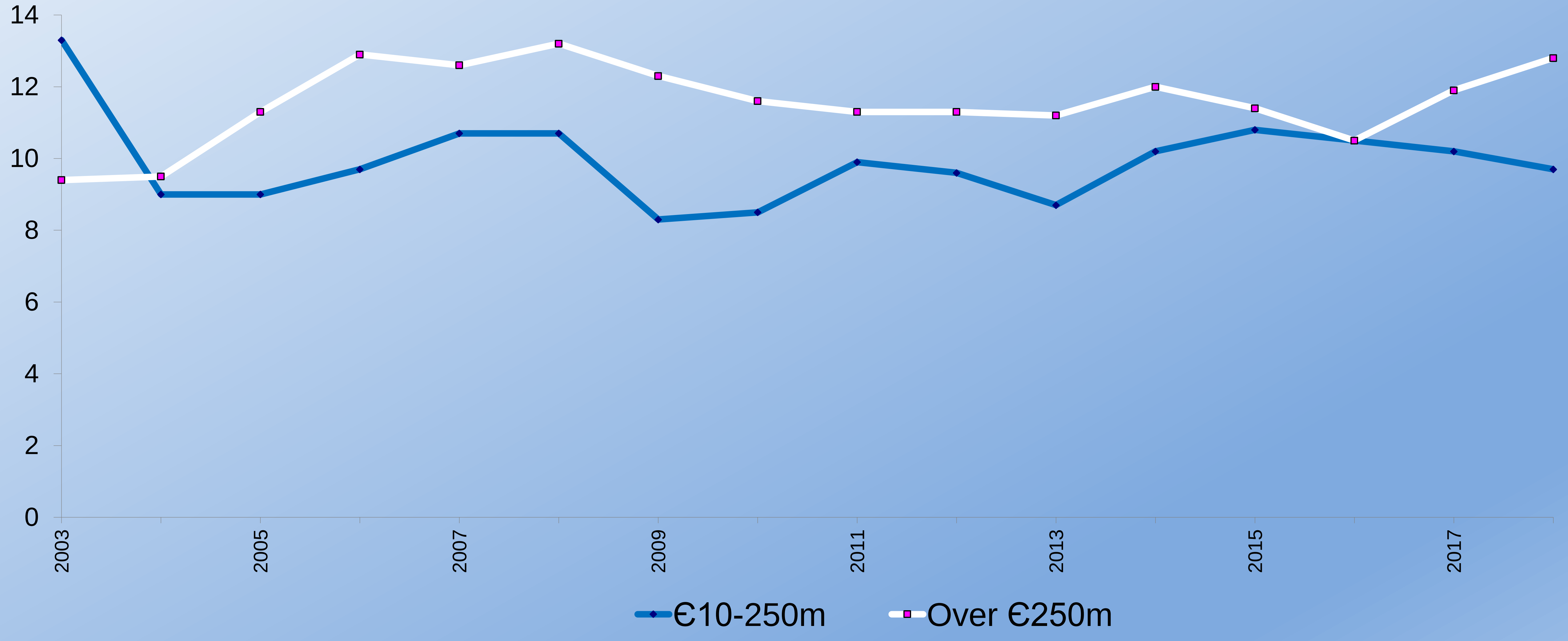
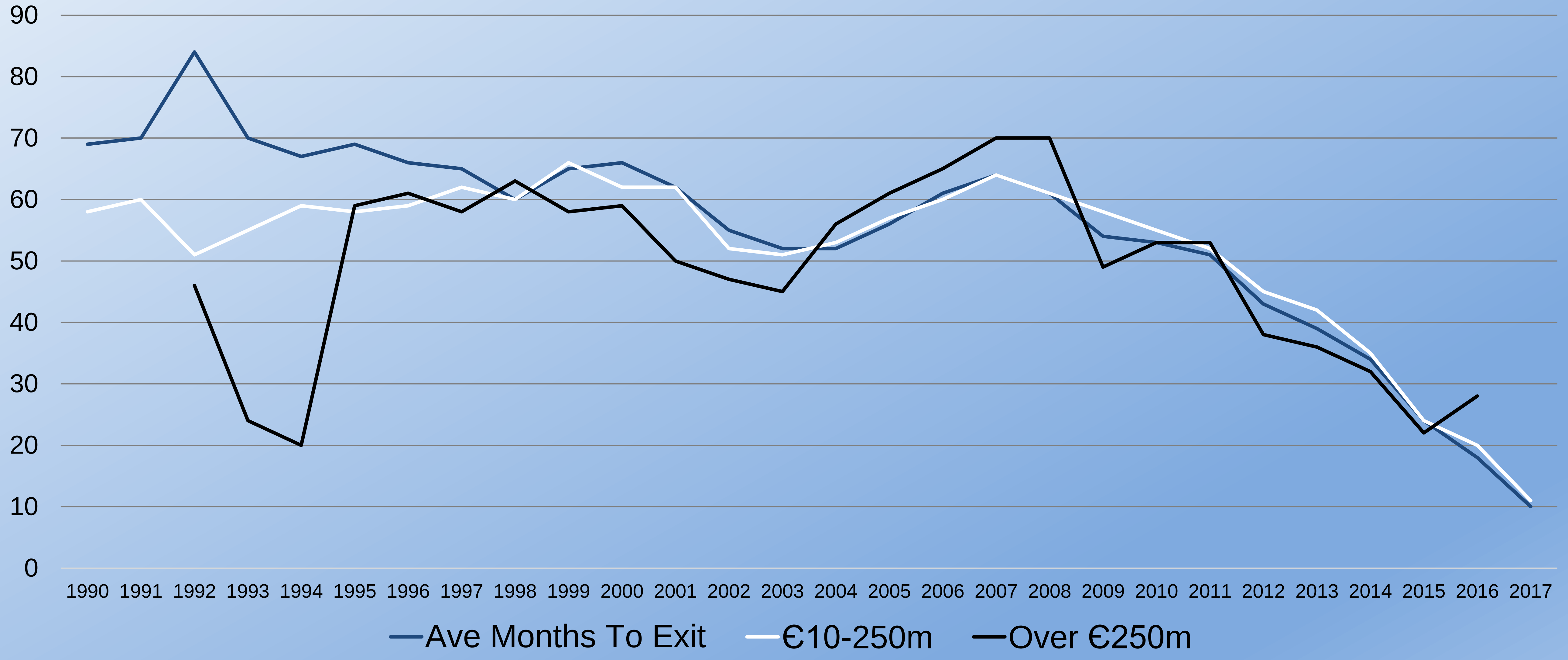
European PE-backed exit EBITDA multiples



Vintage years average time to exit by original deal size



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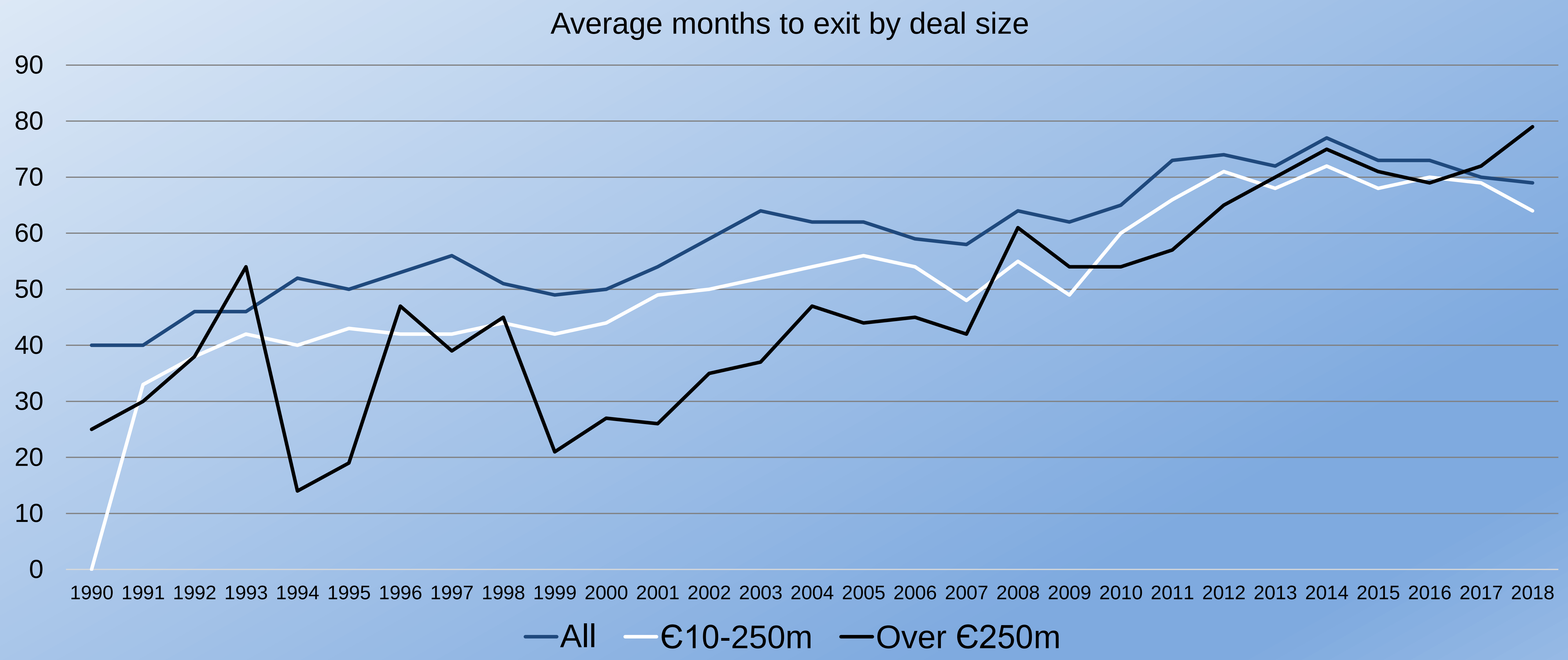
Exit year months to exit by original deal size



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Emerging trends

- **GP to GP secondary deals**
  - Around half of market value but generating returns challenging.

- **Growth in venture and growth capital funds**
  - successful entrepreneurs setting up large funds rather than joining a fund or becoming an angel.

Emerging trends

- **Which strategies are more effective?**
  - single, dual or plural/multi strategies?
  - is this ‘top of the cycle behaviour’ in a crowded area?

- **Greater focus on bilateral deals**
  - Pre-emption rather than risk an auction where the deal might fall over as bidders not prepared to pay the price after due diligence.

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Brexit

- **Uncertainty and potential downturn?**
  - Increased holding periods.
  - More deals from distress, but fewer family firms willing to sell.
  - More deals with efficiency than growth opportunities.
  - If LPs require greater liquidity, will fuel growth in the secondaries market.
  - Caution about deals with new export market opportunities.
  - Foreign divestment deals in UK.
- **Impact of deal form on labour flexibility, labour mobility, state aid, AIFMD**

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Thank you

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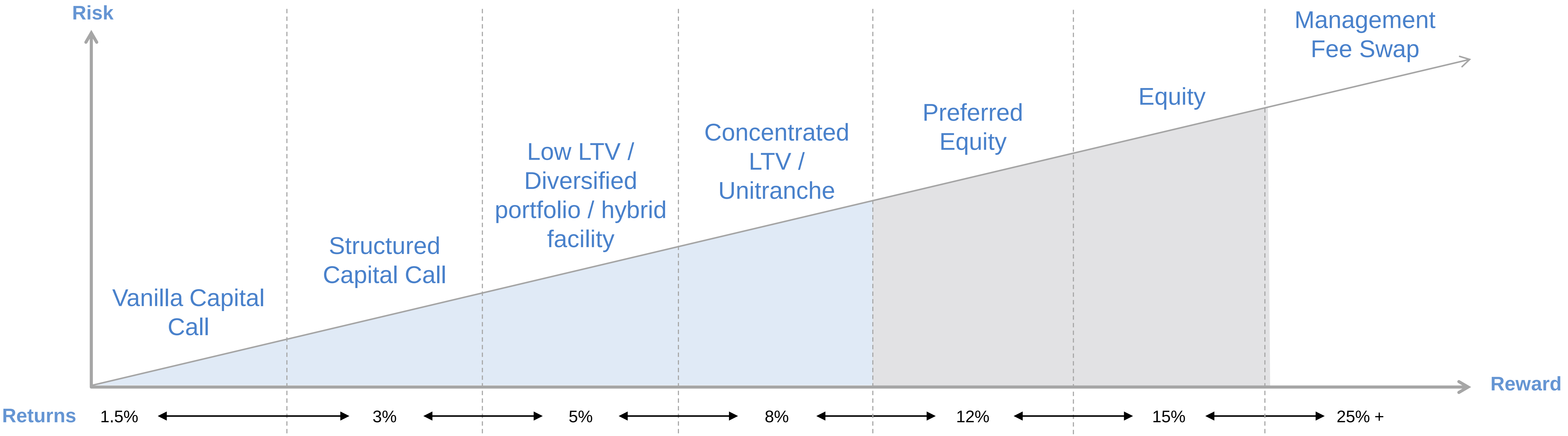
Specialist Bank

Private equity becomes tailored made

Ian Wiese,
Investec Fund Finance

Capital stack available



- Perceived low risk
- Can be externally rated
- Well developed market

- Structured version of capital call
- Increased flexibility
- Good relative risk return

- NAV and undrawn commitments as security
- Funds moving outside of the investment period

- NAV only as recourse
- Repayment through NAV liquidity
- Debt instrument vs. preferred equity

- New solution to PE
- Tailoring of LP fund investment

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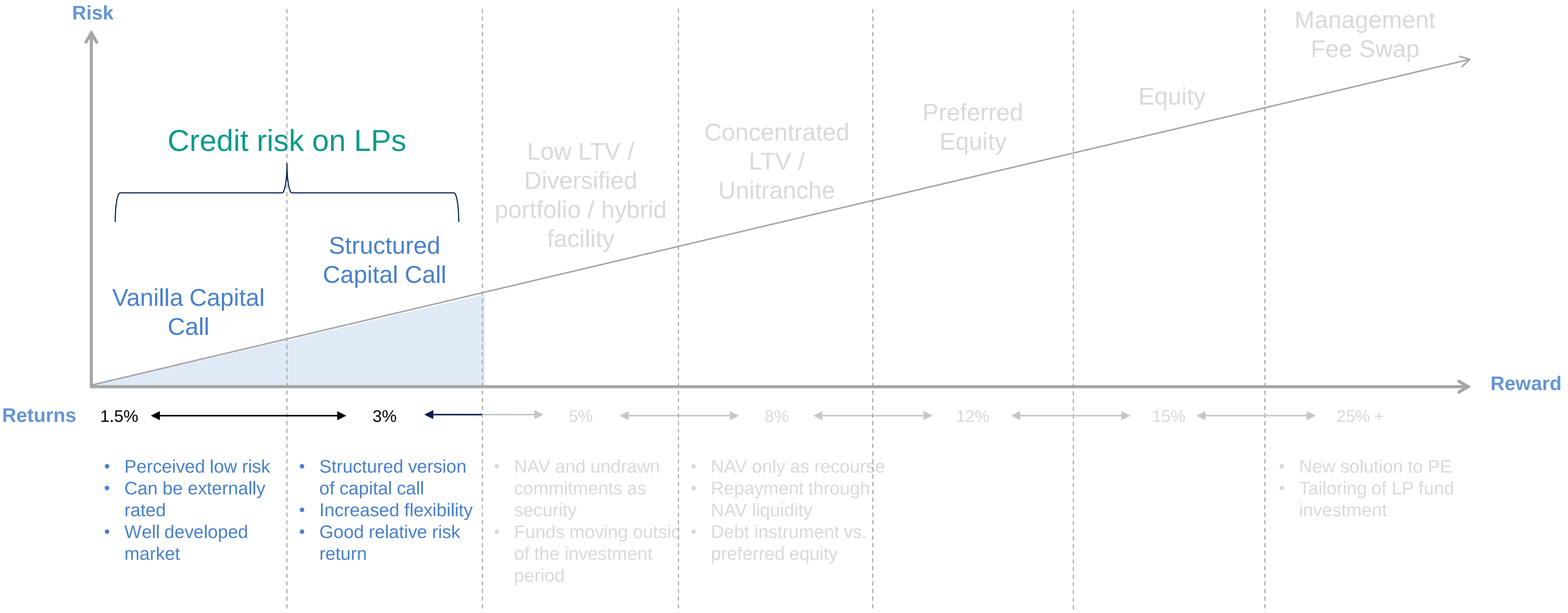
Capital stack available



When bad press makes for good conversations

The media

Last 12 months

"Sub-line facilities: end of the road"

~ PwC

"Private equity's dirty finance secret"

~ Financial Times

"Financing 'trick' boosts private equity fees"

~ Financial Times

"The dividing lines of fund finance"

~ PEI

"Private equity's IRR claims slammed as 'fake news'"

~ The Drawdown

Secondary fund principals

Quotes

"Sub lines are incredible….the flexibility"

August 2018

"Who does not have a subscription facility?"

August 2018

Very large institutional LP

Quote

"Organisationally we have no issue with subscription lines… The only problem we have is with poor disclosure… Sub lines are economically rational for GPs, but if the hurdle is met largely because of them, we are not prepared to continue paying a GP millions of dollars of carry"

September 2018

76% of survey respondents use **subscription facilities** (in line with 2017)

Onus on managers to increase transparency and disclosure with LP

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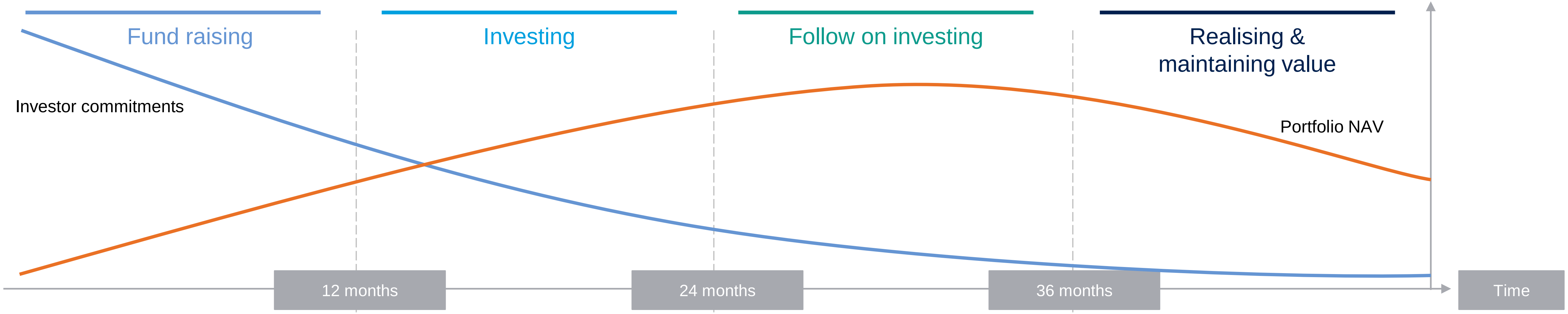
Subscription line relevance



FINANCING

Pre-fund close
- Bridge to second close
- Deal by deal funding
- GP financing
- Warehousing solutions

Initial investment period
- Optimising fund equity
- Cash confirmation facilities
- Bridging LP drawdowns
- Financing bolt-on acquisitions

Late investment period
- Follow-on investments
- Unlocking value where no dry powder
- Smoothing LP drawdowns
- Covenant cure facilities for portfolio investments

Post investment period
- Post investment period Portfolio WC leverage
- Unlocking value/trapped commitments
- Bridge to exit of portfolio investments

HEDGING

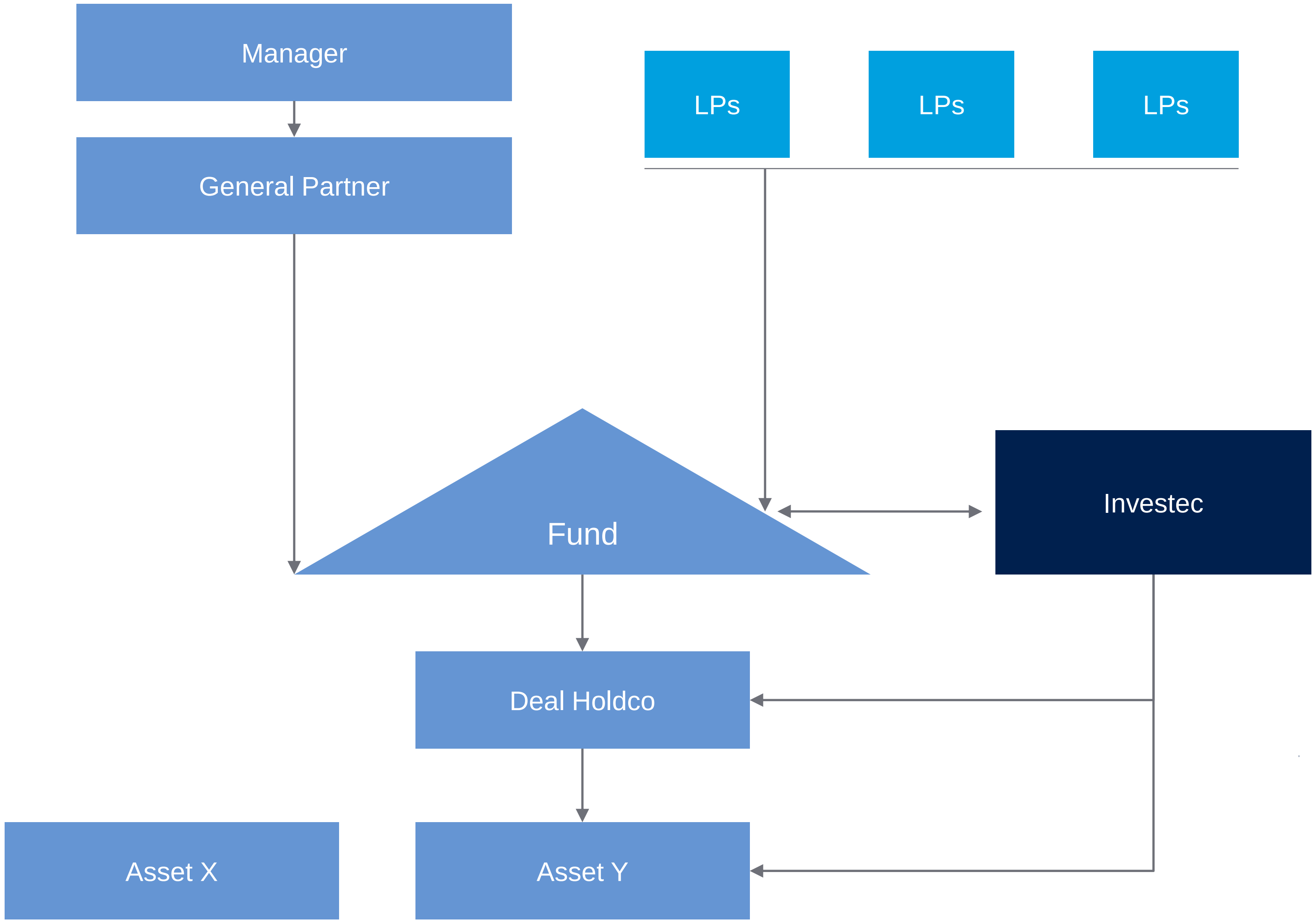
- Multi currency offering to LPs
- Direct LP hedge solutions

- Foreign currency investment
- Asset level pre-hedging and term hedging

- Rolling NAV hedging
- Optimising asset level hedging

- Exit hedging

A typical LP backed structure



Conclusion

Managers are voting with their feet – subscription lines are now firmly entrenched in the secondary and Fund of Fund market

A drive for greater transparency

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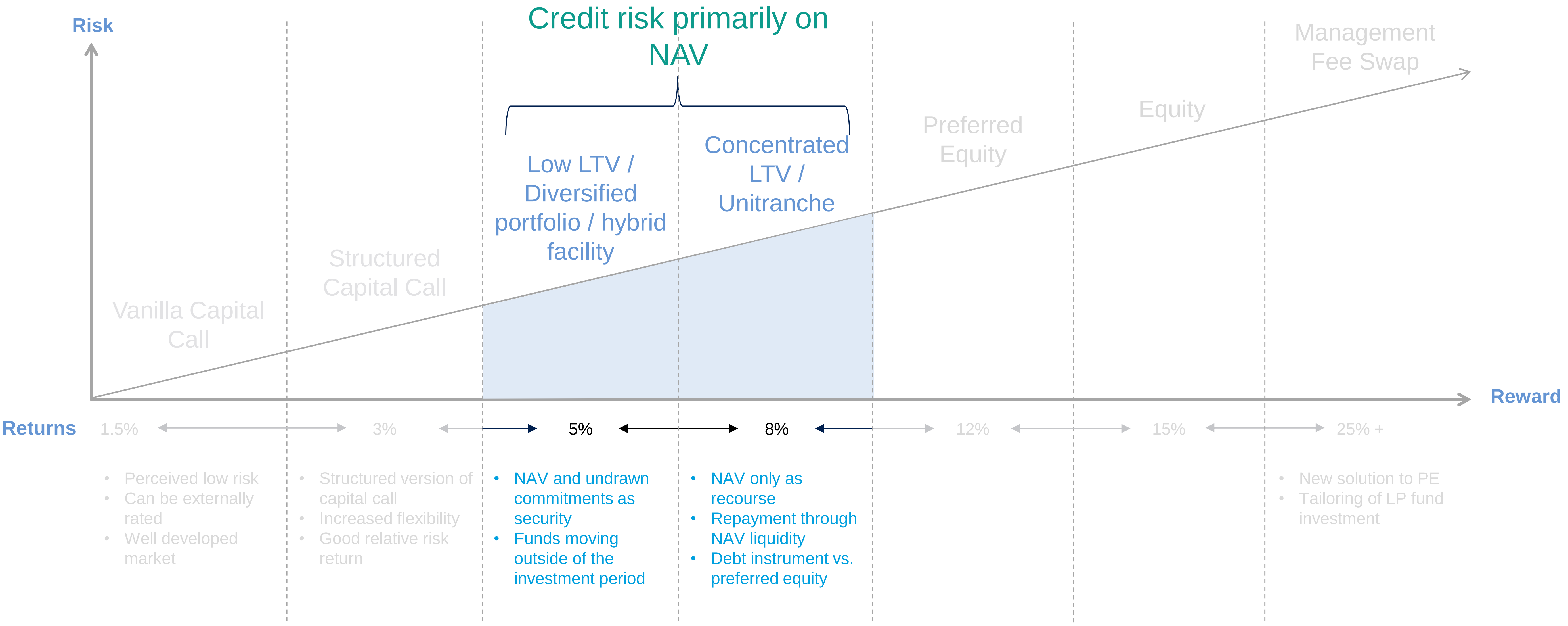
Capital stack available



Types & tools for NAV lending

- RISK +

Hybrid lending

- Primary source of repayment from NAV with additional support from FoF or Secondary Fund to wholly or partly cover loan obligation
- ECL/Commitments made to Borrower which can be cancelled as loan is repaid
- Popular for GP-led transactions given flexibility on sweep, LTVs, pricing
- Facilities will include covenants that ensure that there is sufficient headroom of undrawn investor commitments, as well as ensuring that the net asset value of the fund remains above a minimum level

Diversified NAV lending

- Risk against diversified FoF portfolios or large LP portfolios of primary funds (portfolio risk)
- Repayment through liquidity of portfolio only (generally distributions over a 2-3 year period)
- Bottom up analysis may be difficult in the case of FoF portfolios (lack of granular information)

Concentrated NAV lending

- Risk against concentrated assets (generally companies rather than LP interest)
- Asset expertise may be required (less portfolio lending) with increased DD
- Primary source of repayment:
  - Liquidity events with high probability.
    - Sale of assets
    - Refinance at underlying company that will result in distribution

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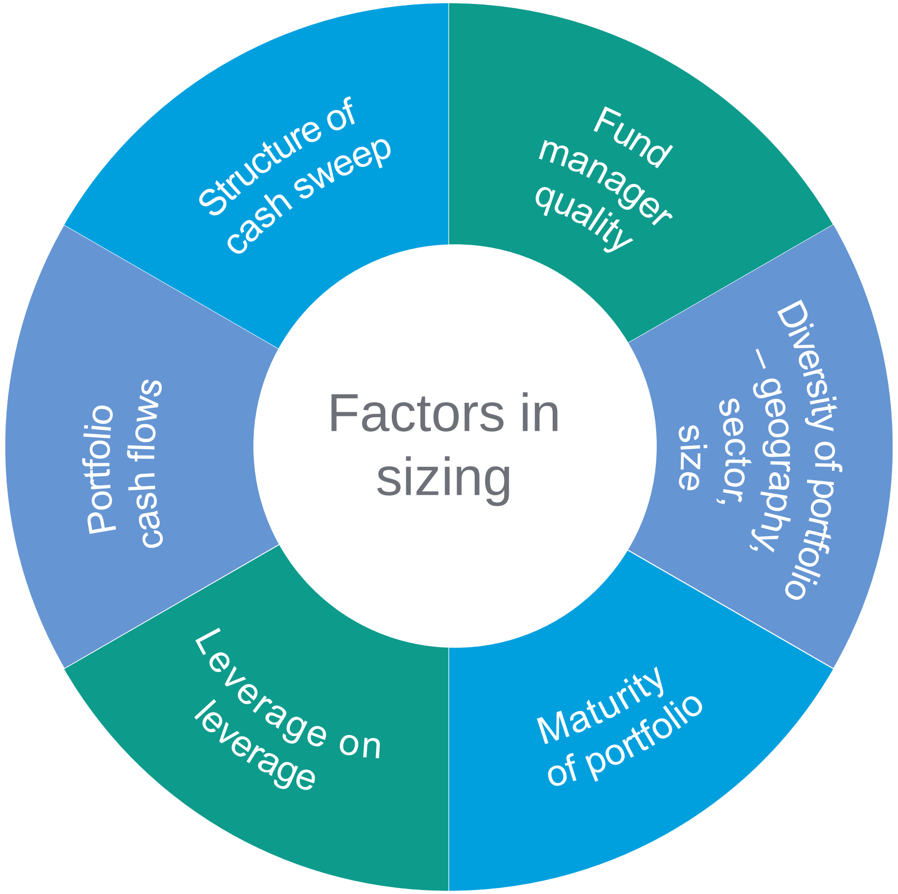
Diversified portfolio lending

Market developments:

Average tenure of facilities increasing with the average facility tenure being around 3 years:

- LTVs being requested is stabilising and have softened over the last 6 months
- Cash Sweeps have become much more negotiated
- Margins have stabilised but pricing ratchets more common
- More work being conducted on underlying portfolios (liquidity forecasts) and exploring ability to conduct “bottom up” analysis for significant positions
- Stress testing covenants in line with events in GFC



46% of survey respondents currently use **SPV financing** *(up from **29%** in 2017)* and **66%** believe that you need some form of financing support to be competitive in acquiring a diversified LP portfolio

Hybrid lending facilities

Rationale for use vs NAV backed:

Reduced margins and increased LTVs

Asset security requirements may be relaxed

Overall flexibility (cash sweeps, LTV)

Developments:

Majority of our GP-led financing solutions use a hybrid structure as the underlying portfolio is generally very concentrated (4 or less assets) and ring-fenced NAV facility will be significantly higher priced at lower LTVs

20% of survey respondents currently use **Hybrid financing** *(up from **10%** in 2017)*

Your questions answered…

…relating to **diversified portfolios lending**

LTV covenant breaches on portfolio deals	Distributions behaviour on your portfolio	Downturn scenario modelling being conducted	Behaviour maturity
The average LTV being advanced	The most common structures being used	Hedging trends (FX and interest rate)	Are you providing stapled debt packages to portfolio transactions

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Your questions answered…

…relating to **GP-led and concentrated portfolios**

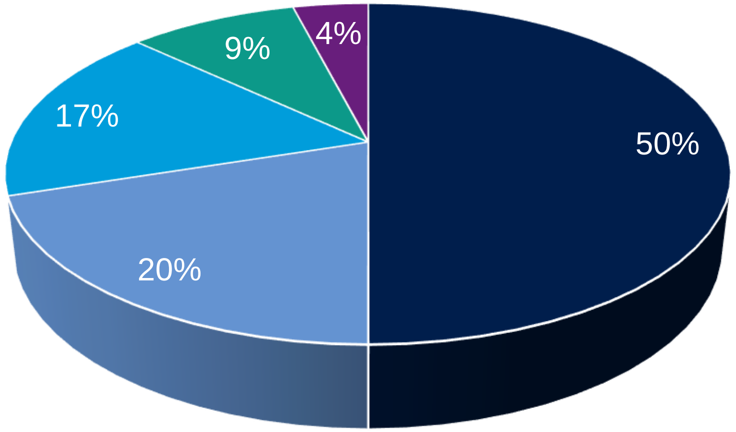
Is the financing generally advanced at the continuation vehicle?

Are these facilities generally ring-fenced NAV facilities?

What is the average tenure of these facilities?

Any considerations to think about when considering whether financing appropriate

GPs' approach to managing mature funds – how things have changed in the last 2 years



- Wind down the fund
- Use to anchor stapled secondary
- Restructure the fund
- Asking LP to make further commitments
- Using debt to further fund investment into portfolio

Source: Investec 2016 GP Trends Report

Banks’ view in analysing leverage

Understanding ‘leverage on leverage’ for banks is a main factor assessed both on diversified and concentrated portfolios

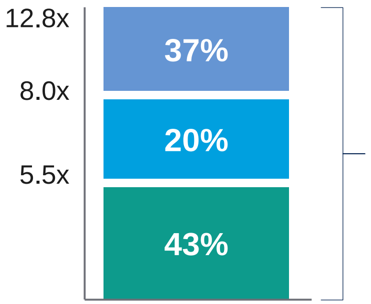
The more concentrated the more will be done to understand each level of debt

We have received many queries on how we analyse the capital stack and what sensitives do we run

Put very simply:

Assume a secondary fund is acquiring LP positions in European focused primary funds. Using the CMBOR data in respect of European primary market LBOs:

- Average company level gearing at 5.5x EBITDA
- Average valuation multiples today, EV/EBITDA multiple 12.8x, thus equity is 7.3x EBITDA
- Client request is to apply 35% LTV of leverage
- After analysing the portfolio diversity (sector, strategy, vintages), we would then analyse total debt
- Depending on vintage of the funds subscription finance facilities may also have to be factored in
- At 35% LTV on equity of portfolio (35% of 7.3x) – additional 2.55x leverage is put into the system



Whilst 35% LTV requested seems moderate on a look-through leverage of 8x EBITDA or 63% LTV is quite full

With this example, sensitivities are run to test when equity is wiped out and the bank becomes at risk of loosing capital:

- If average portfolio EBITDA of 10, if this decreases by 40% the entire equity stack is wiped out (multiples remain constant)
- Similarly, if EBITDA remains constant but multiple’s soften, all equity is wiped out at 7.8x EV/EBITDA
- In a crises both EBITDA and multiples tend to soften. All equity wiped out when:
  - 20% drop in EBITDA
  - EV/EBITDA multiple’s drop to c9x (GFC EV/multiples dropped to 8.3x)

Takeaway: a moderate level of gearing that can withstand a market correction is the optimal position.

Whilst this is a simplistic way of looking at it.

Your questions answered…

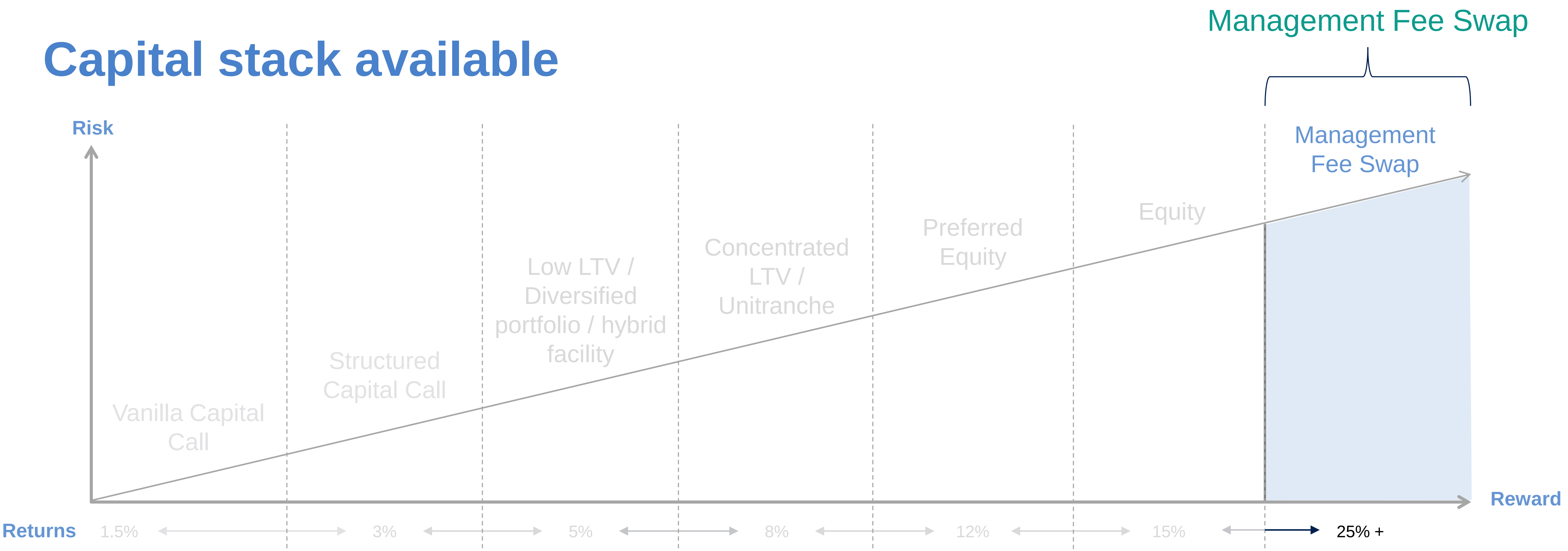
…relating to **Investec Fund Finance**

What is your minimum ticket size for a transaction?

What is your maximum underwriting capability?

How quickly can you implement a deal from receiving information to funding?

Capital stack available



- Perceived low risk
- Can be externally rated
- Well developed market

- Structured version of capital call
- Increased flexibility
- Good relative risk return

- NAV and undrawn commitments as security
- Funds moving outside of the investment period

- NAV only as recourse
- Repayment through NAV liquidity
- Debt instrument vs. preferred equity

- New solution to PE
- Tailoring of LP fund investment

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How sophistication in the market is driving innovation

Matt Hansford,
Investec Fund Finance

Investec
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Fund Unitranche Capital

Fund Unitranche Capital – what is it?

Overview

- A blend of pref equity and asset backed (NAV) capital
- Blended risk capital allows for higher LTV or more flexibility (vs debt) but lower cost than equity

Uses

- A secondary acquisition where typical asset backed debt is not possible
- Dividend recaps
- Optimising the capital structure of a GP-led deal
- Particularly complex transactions such as GP stake acquisitions

Structure

- Security over the assets/holdco/cashflows
- Borrowing entity can be flexible
- Term typically 12 months +

Cost

- Typically 6%-10%
- Usually PIK

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Why share? – beating concentration issues

If a complex deal is too large an equity exposure but bringing in an equity partner doesn't add value

Secondary Firm A
The deal "Originator"

Secondary Firm B
The deal "Club Partner"

Returns

1.8x MM

Equity: 130
Returns: 234

Returns

1.8x MM

Equity: 70
Returns: 126

Secondary Firm A
The deal "Originator"

Fund Unitranche Capital

Returns

2.1x MM
Equity: 130
Returns: 276

Returns

1.2x MM
Debt: 70
Returns: 84

Result

Base Case Multiple: 1.8x MM

Unitranche Case Multiple: 2.1x MM

Multiple Increase: 0.3x / 16.7%

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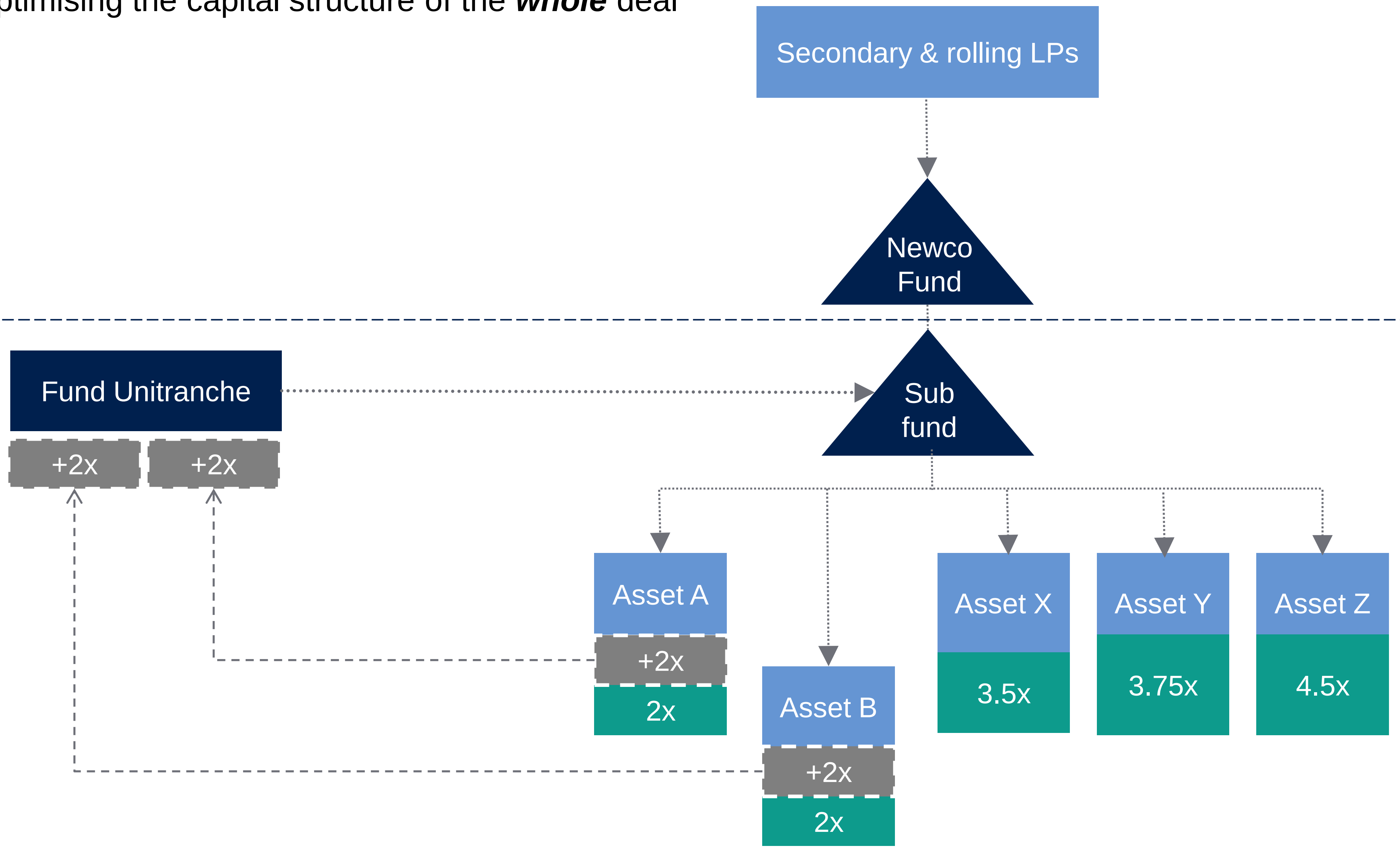
GP-led / complex situation

Optimising the capital structure of the ***whole*** deal



No looking up

No connection to the fund

Tax / AIFM / rolling LP considerations

Optimise the asset cap structure at the holdco

Remove friction and risk of refi's

Space for growth

Work around shareholder issues

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Management Fee Swap

Evolution of the asset class

The next decade will see the adoption of sophisticated financial engineering products for funds and LP's such as Management Fee Swaps, PE fund derivatives and LP PE portfolio hedging.

- Angel investing: Vanderbilts, Rockefellers and Bessemers
- SBICs & Limited liability partnerships
- Regulation: tax reduction & ERISA
  Pension funds investing in PE
- LBOs & 'Barbarians at the Gate' – KKR (1976)
- Secondaries
  PE funds
- Sarbanes–Oxley & Low interest rates (2002)
- Co-investments, co-investment funds & Separately Managed Accounts (SMAs)

1930s & 1940s	1950s & 1960s	1970s	1980s	1990s	2000s & beyond

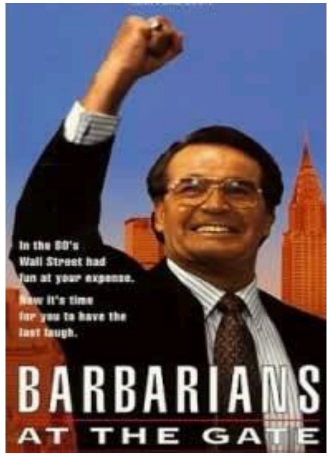
Venture Capital firm:
J.H. Whitney (1946) | KPCB (1972)

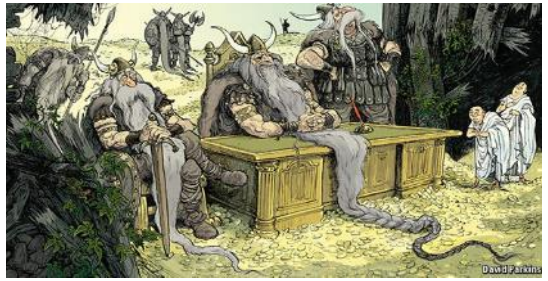
Buyout fund:
THL (1974)

Fund of Funds:
Adam Street (1979)

Secondaries PE:
VCFA (1984) | HarbourVest (1986)

PE firms IPO:
KKR (2006), Blackstone (2007)





"Private equity has prospered while almost every other approach to business has stumbled."

The Economist, October 2016

Over the last decade (and a bit) – advanced leverage and other solutions for LPs

- Securitisation and non-recourse leverage against LP interests in PE
- Bridging and other financing solutions for funds:
  - Capital-call facilities (subscription line facilities)
  - Asset backed facilities (NAV or ABL facilities)
- Currency (and interest rate) hedging solutions for funds
- GP led secondary (end-of life solutions)
- GP stake sales

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…yet management fees are still the main point of contention

2/3 LPs see management fees as the most important term to be negotiated. Up from 40% and 54% in 2014 and 2015.

91%

of surveyed LPs have decided against investing in a fund due to the proposed terms and conditions.

Bloomberg

Private Equity's Biggest Backers Are Tired of the Fees

Love the returns. Hate the fees. Is it time to go solo?

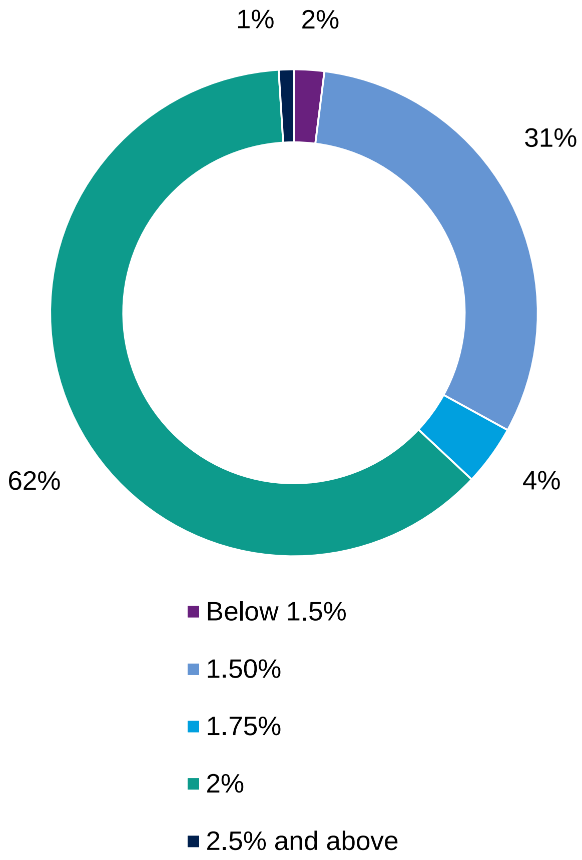
By **Sonali Basak** and **David Carey**

October 26, 2017, 11:00 AM GMT+3 *Corrected* October 27, 2017, 12:33 AM GMT+3

From **Bloomberg Markets**

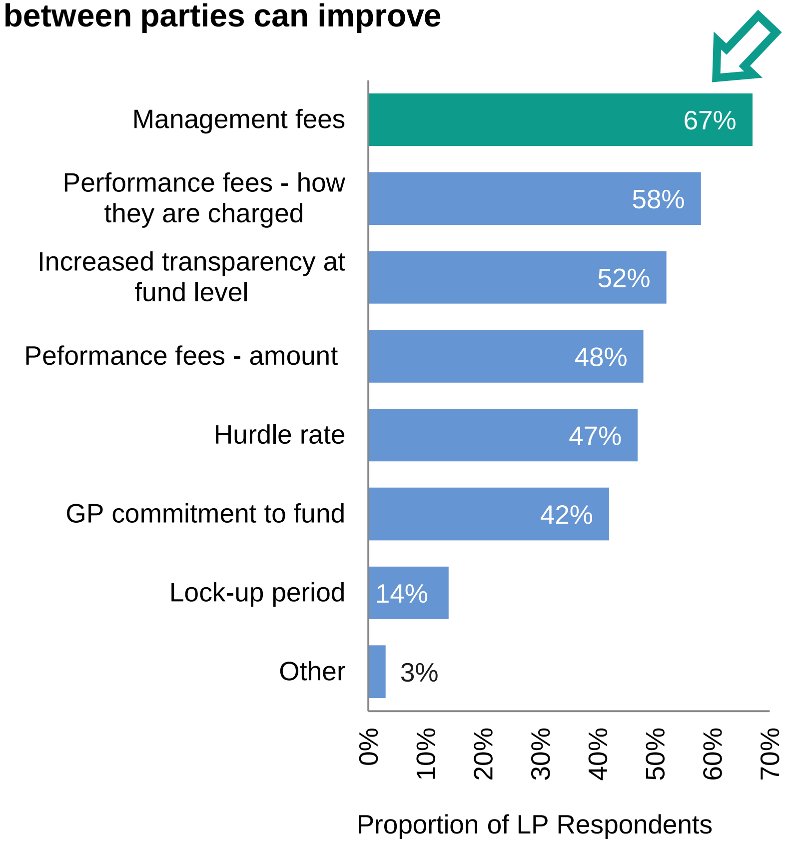
The biggest U.S. pension fund isn't happy. After years of paying steep fees to private equity fund managers, it's plotting an end run. Officials of the California Public Employees' Retirement System, which oversees about $337 billion, gave fund managers an earful at a pension board meeting on July 17 in Monterey. Huffed one CalPERS director: "I don't see

2017 Management fees



Source: MJ Hudson PE Terms Research 2017

Figure 3. Areas in which LPs believe alignment between parties can improve



Source: Preqin 2017 Private Capital Fund Terms Advisor

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The Management Fee Swap (MFS)

An equity solution that swaps payment of management fees for a share of upside

Reducing management fees:

- No management fee during the investment period (or part thereof).
- Capping management fees, including double-layer.

1

Swapping a fixed cost for a variable one

- Subject to the fund performing
- The quantum is mostly a rounding error: 1.5x net to 1.47x
- Is marginally of substance when the fund performs exceptionally well: 2.1x net to 1.95x

2

J-Curve mitigation strategy:

- Lower annual fixed cost
- Capital swap can have massive impact on early years' NAV
- Can fund other costs
- Improved TVPI / DPI until DPI reaches 1x
- Pension funds actuarial accounting

3

The underlying GP is agnostic to the trade:

- No change to business model
- No change to incentives or risk propensity
- Solves an LP issue – helps fundraise
- Averts the negotiation of fees
- Innovative – think capital calls 5 years ago

4

LPs pay for MFS only if the fund performs

LPs pay for the Management Fee Swaps only back-ended in the fund's life and only if the fund has performed.

- **NO fixed cost** upfront,
- **NO set-up fees** and
- **NO interest to pay.**

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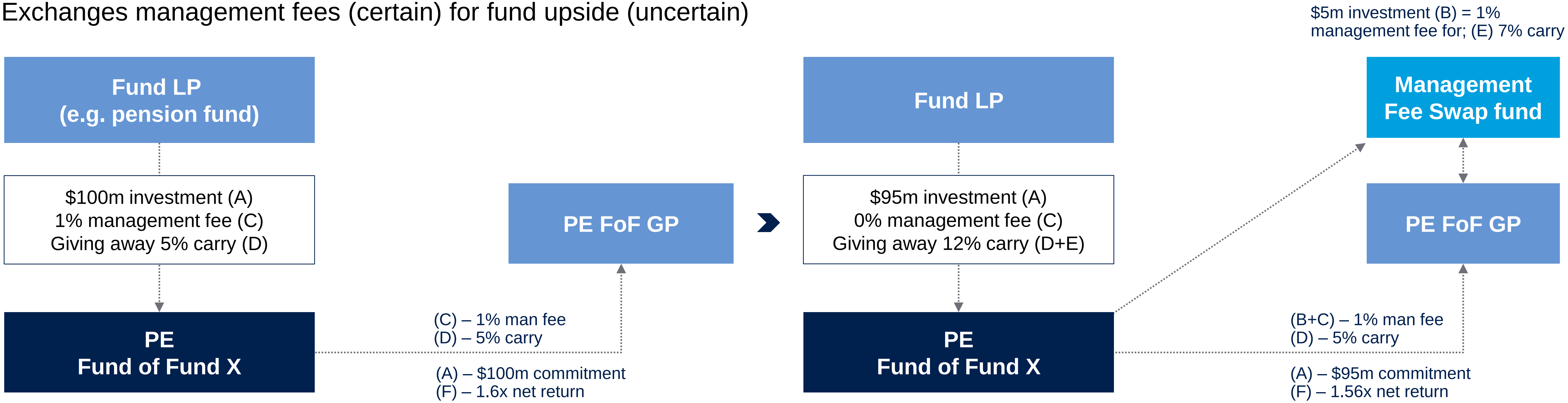
The mechanics of a Management Fee Swap

Exchanges management fees (certain) for fund upside (uncertain)



Fund LP – without MFS

Commitment (A)	$100m
Amount funded	$100m
Management fee (investment period) (C)	1% p.a.
Carry (D)	5%
Net multiple returns (F)	1.6x

Fund LP – with MFS

Commitment (A+B)	$100m
Amount funded by investor (A)	$95m
Effective management fee after reduction for MFS investment (5 year investment period) (C)	0% p.a.
Effective carry (D+E) (5% for GP and 7% for MFS)	12%
Net multiple returns (F)	1.56x

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Innovation already…

Discussions with the FoF and Secondary community have already produced innovative ways of adapting the solution

1

Fundraising tool

- Can be offered as part of a co-mingled fund
- SMA solution – ultimate in “tailoring”

2

Remove the premium

- To pay the premium in a secondary acquisition
- Allows J Curve sensitive mandates/funds to participate in the transaction

3

Release the fees in a portfolio for reinvestment

- Backstop the fees in a larger portfolio/fund
- Amount can be reinvested immediately for increased IRR gain

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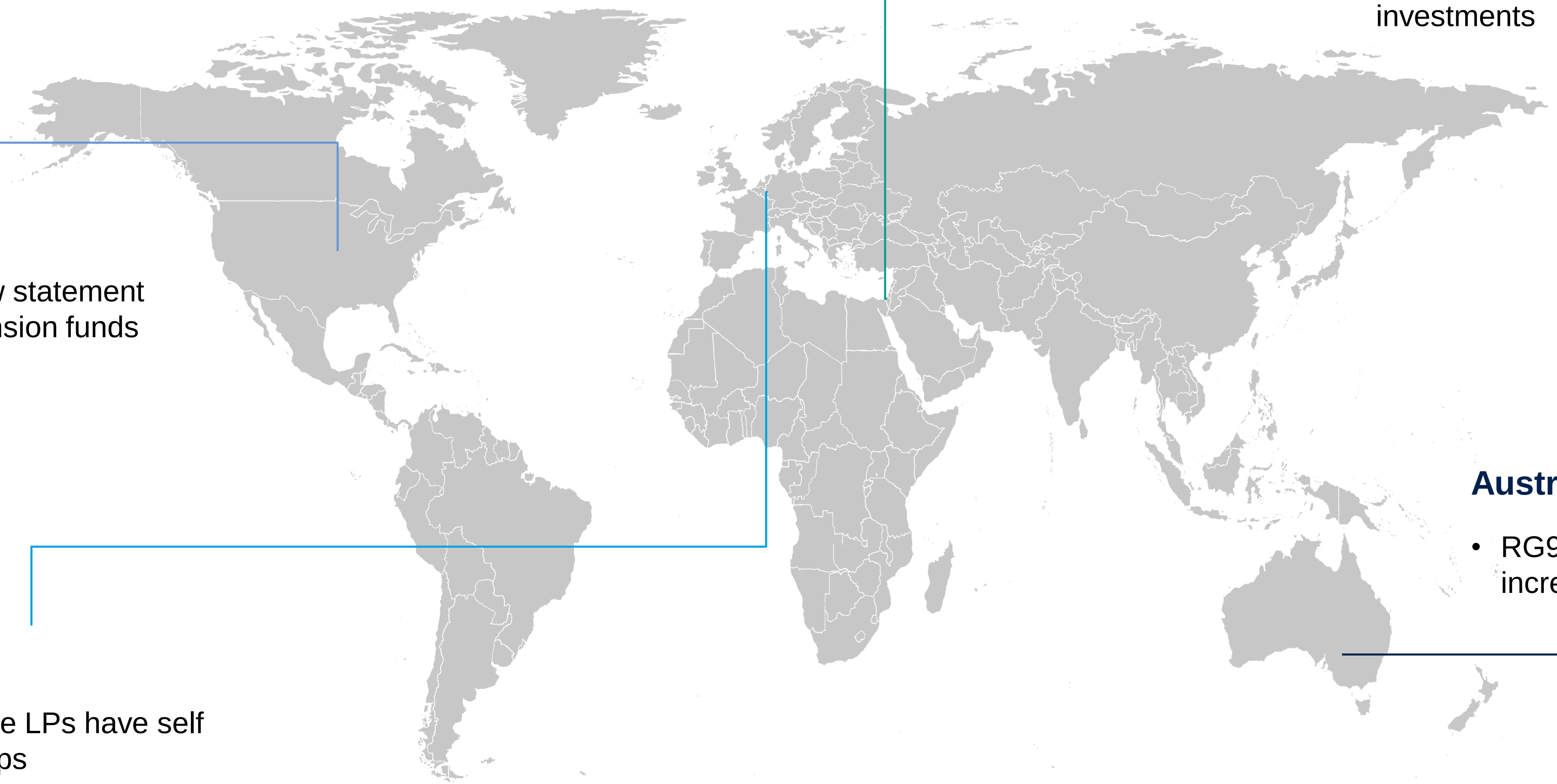
LP interest

So far we have identified a number of pockets of LPs with which the MFS resonates firmly



USA

- Every week a new statement from US state pension funds on PE fee levels

Europe

- Varied, but some LPs have self imposed fee caps

Israel

- “25 bps” rule puts pressure on PE investments

Australia

- RG97 has made LPs incredibly fee sensitive

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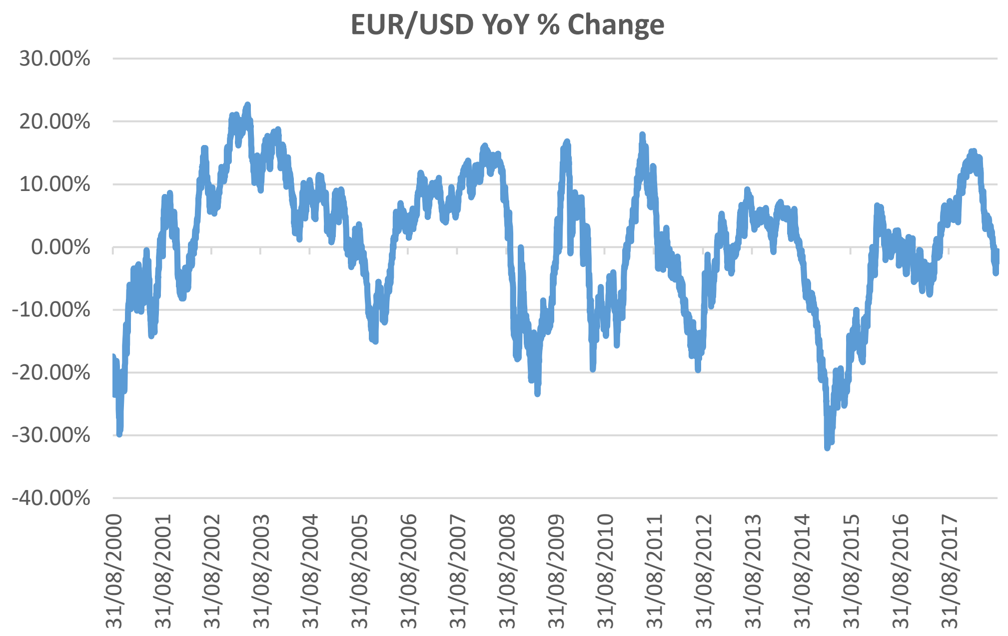
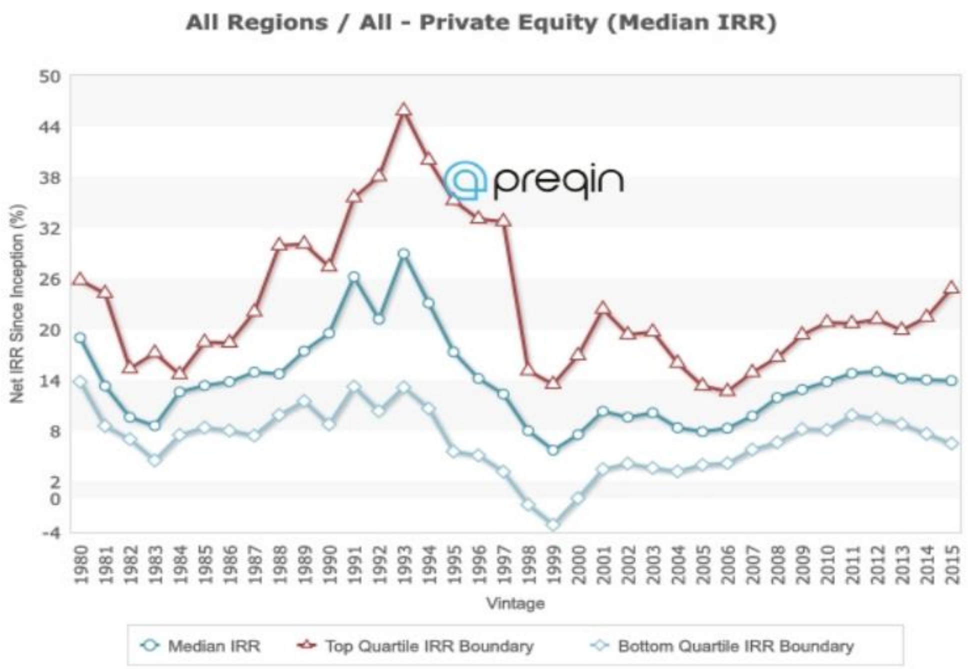
Changing attitudes towards hedging

Joe McKenna,
Investec Fund Solutions

Why do funds hedge?

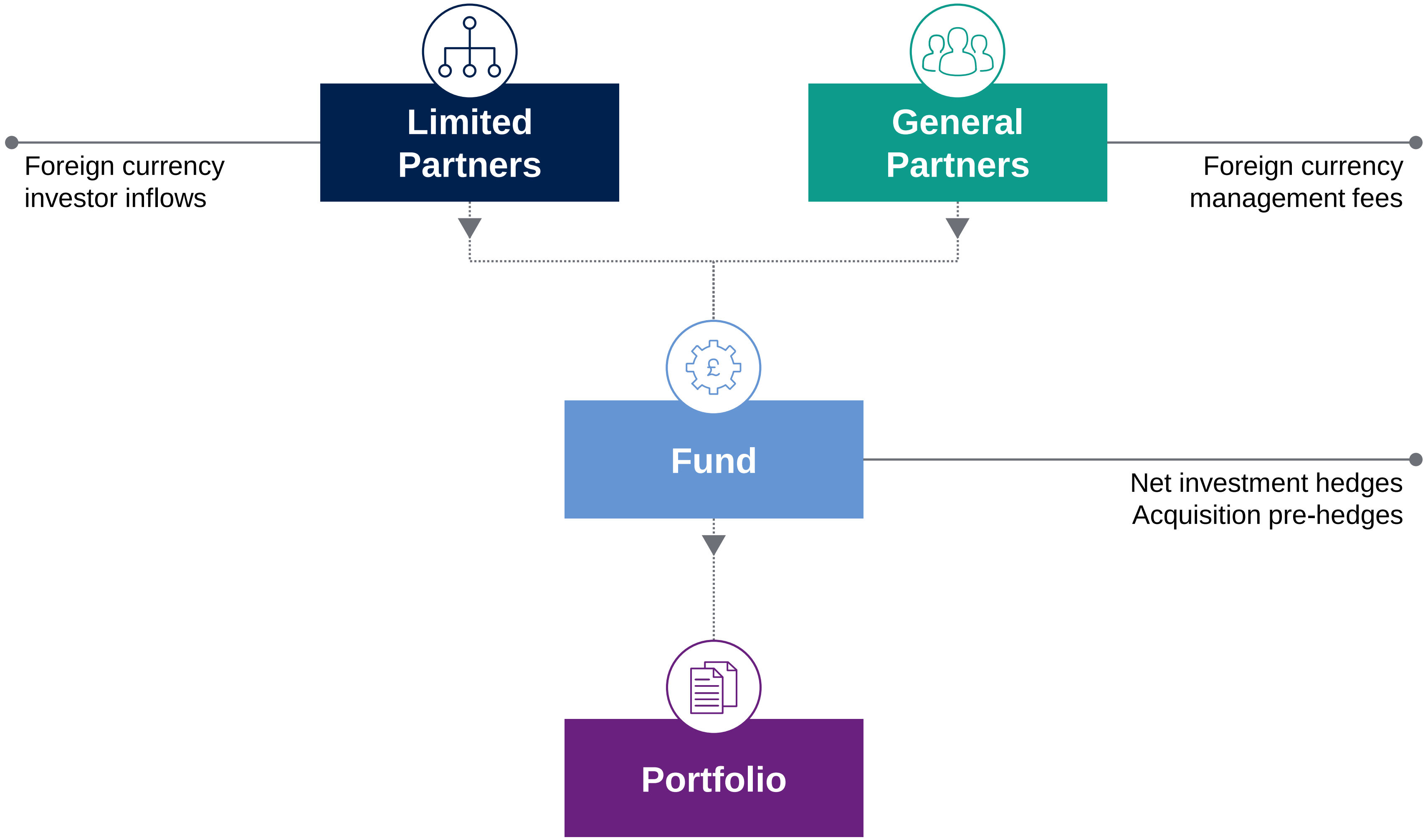




Private Equity IRRs since 2000 between 10% and 14% *(Source: Preqin)*

The world’s largest currency cross, EURUSD, has seen year on year changes ranging between **+23% and –31% since 2000** *(Source: Bloomberg)*

Where we can help



Where we can help

LP / share class / feeder fund hedging

- Lessen the exposure to movements between the dealing currency and the base currency of the fund throughout the life of the investment
- Create a broader investor universe, leading to increased shareholder diversification

Management fee hedging

- E.g. A fund receives USD quarterly management fees but has a GBP cost base

Buying / selling foreign currency assets

- E.g. A Euro denominated fund is purchasing a Sterling asset and needs to cover the initial conversion and simultaneously plan for disposal

Portfolio company

- Investec work with corporates throughout the UK to help manage FX, IR and commodity risk

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Tools available

Spot – high FX risk, full benefit if the rate moves in your favour

Forwards (& swaps) – no FX risk, opportunity cost if spot moves in your favour

Vanilla option – no FX risk, full benefit if rate moves in your favour, BUT the client pays a premium for the benefit e.g. GBPUSD 12 month call option is roughly 3%, deferred premium available

Zero premium option structures – participating forward, forward extra, collar / range forward, no FX risk, some benefit if spot moves in your favour but might not leave you in a stronger position versus the forward rate e.g. GBPUSD 12 month forward rate is 1.31 versus 1.27 on participating forward

Outperformance – leveraged forwards, extendable forwards, TARFs (the list is endless!)

N.B. Almost 100% of FX deals for funds have been forwards or swaps

FX Forward

- An FX forward is a contract under which an amount of currency is committed to be bought/sold on a future date

- There are two main components when working out the forward FX rate:
  - The spot rate at the time the forward is agreed
  - The interest rate differentials between the two currencies of the forward contract

- The interest rate differential will result in a better/worse exchange rate compared to spot when the interest rate environment of the currency being bought on the forward date is higher/lower than the one being sold

- It is possible to move the delivery date of an FX forward through the use of FX swaps (see "FX Swap" slides)

Example

- Assume a client is looking to sell EUR / buy GBP forward and that interest rates in GBP are higher than EUR
- Here the forward point adjustment to spot would be negative, decreasing the GBPEUR rate and resulting in a better rate for selling EUR forward when compared to spot

Benefits	Considerations
• Certainty over future exchange rate • Where credit lines allow, delivery date can be moved through use of FX swaps (see considerations also)	• Amount to hedge and delivery date • Potential break costs if required to unwind in part/full • Cash flow implications if changing delivery date (see "FX Swap" slide)

FX swap

- An FX swap is a contract where a currency pair is bought/sold on one date and sold/bought back on a future date
- FX swaps are often used to:
  - hedge the FX risk associated with a foreign currency investment strategy; or
  - move the timing of an existing FX settlement
- Cash flow considerations when moving settlement date
- Where clients have an FX delivery that they wish to delay, they effectively reverse the transaction on the near leg of the swap and have the same direction as the original trade on the far leg
- The near leg cancels out the existing settlement moving the FX settlement to the far leg
- FX swaps have to be entered into at prevailing market rates meaning there will be a cash flow implication if the FX rate for the near leg of the swap is different to the original forward rate
- This is a cash flow implication rather than an economic implication as the FX rate on the far leg is also based on market rates at the point that the swap is booked, reversing the cash flow effect on the near leg
- The FX rate on the far leg of the swap is also adjusted for forward points in the same way as a standard forward contract
- See next slides for FX swap examples

Benefits	Considerations
• Ability to move the timing of an FX forward settlement • Ability to hedge entry/exit FX rate on foreign investments	• Cash flow implication when moving settlement dates • Forward points incurred

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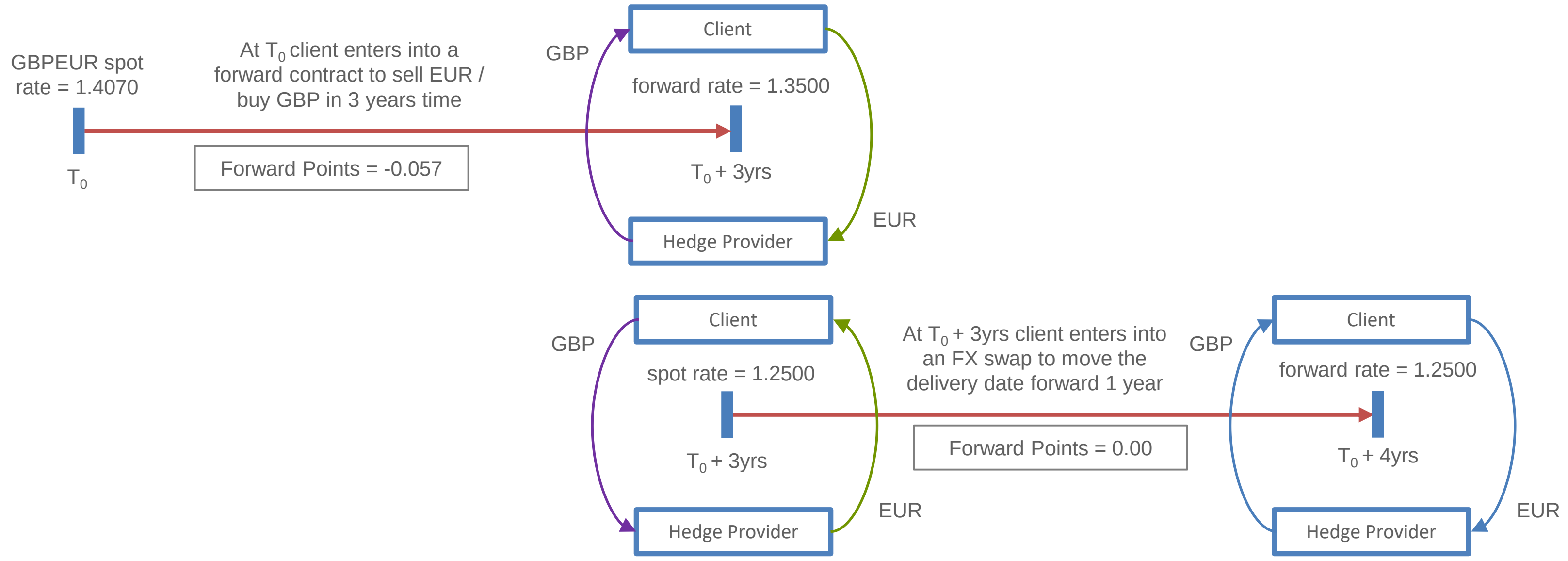
FX swap example 1

Moving timing of an existing FX settlement date

- A client has entered into a forward contract to buy/sell currency 3 years forward, but looks to move settlement forward 1 year
- An on market FX swap is used to move the settlement forward. In this example, the FX rate has improved meaning the client has to pay a cash flow on the near date of the swap (To+3yrs), but has an improved FX rate on the far leg (To+4yrs)
- Note: Whilst highly unlikely, for simplicity of this example it is assumed that the additional 1 year forward points are 0

Diagrammatical representation



Tabular representation

		FX Spot	Forward Points	FX Forward Rate	Client Buys	Client Sells
Original FX Forward	To	1.4070				
	To+3		-0.0570	1.3500	GBP 50,000,000	-EUR 67,500,000
FX Swap	To+3	1.2500			EUR 62,500,000	-GBP 50,000,000
	To+4		0.0000	1.2500	GBP 50,000,000	-EUR 62,500,000

Cash flow at To+3 -EUR 5,000,000

Improvement in far leg FX rate

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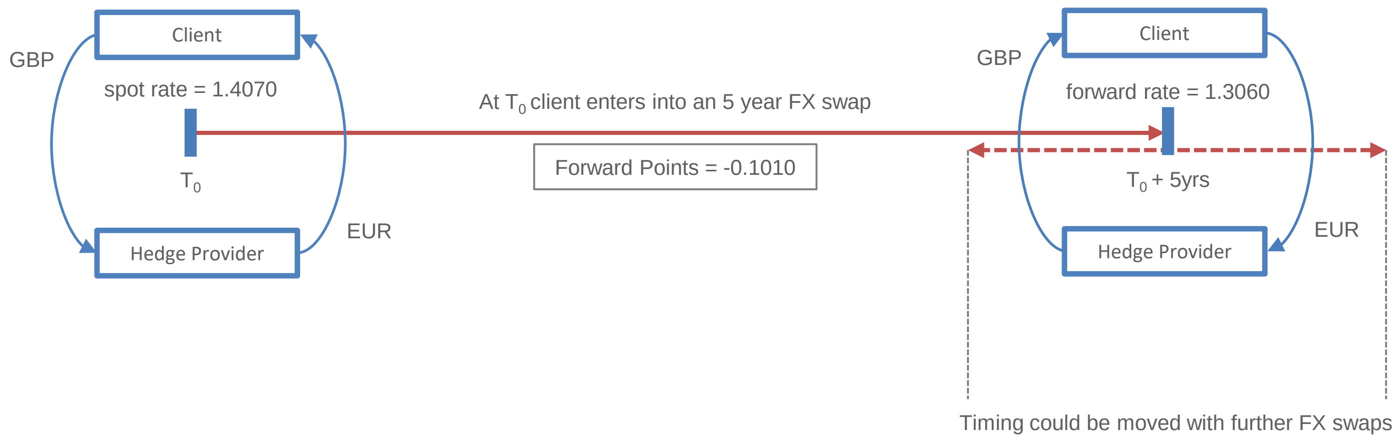
FX swap example 2

Hedging entry/exit FX rates on foreign investments

- The client wants to ensure that both the entry and exit FX rates are locked at the point the investments are made
- The client could do this through:
  - a combination of a spot trade (sell GBP, buy EUR) at the point of the investment and an FX forward (sell EUR, buy GBP) to the anticipated exit date; or
  - by entering into an FX swap at the time of the investment
- These strategies are essentially the same, but the swap ensures there is no timing difference in the underlying spot rates used to determine the rates for entry/exit



Historic rate rolls

When a maturity date is reached on a hedging contract, if clients wish to delay FX delivery they can roll the position to a new future date, typically using an FX swap (see appendix).

The difference between the initial hedge FX rate and the new FX swap rate introduces a cash flow.

If a AUD hedge has been put on and the USDAUD FX rate falls, a negative cash flow is realised, but the new hedge is put on at a better rate. To avoid realising a cash flow clients can use an Historic Rate Roll ("HRR").

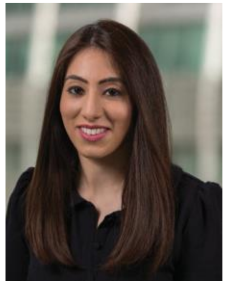
Duration (months)	0	1-year	2-year	2.5-years
Hedge rate	1.3200	1.2540	1.1913	1.2509
Client selling AUD	20,000,000.00	20,000,000.00	20,000,000.00	20,000,000.00
Client buying USD	15,151,515.15	15,948,963.32	16,788,382.44	15,988,935.66
Cashflow (-ve is client making settlement)		-797,448.17	-839,419.12	799,446.78
Cummulative client cash position (-ve, or +ve)		-797,448.17	-1,636,867.29	-837,420.51

In the example above, the client has rolled a forward contract for 1 year, 1 year again and then 6 months before settling the contract. In year 1 and year 2 there would normally be a negative cash flow without the use of HRRs.

A USD Fund has holds a AUD asset. As the fund is valued in USD this introduces FX risk. To hedge this, the AUD value of the asset is sold using a Forward FX selling AUD vs. USD	Before maturity an FX swap is traded to delay AUD delivery. FX swap: AUD is bought to close out the current hedge and sold forward to put on a new hedge.	The process is continued for as long as the fund holds the AUD asset

An HRR allows hedges to be rolled with zero immediate cash settlement. Clients would typically use this to defer a payment when a hedge has been closed out at a loss. The deferred settlement essentially becomes a loan to the client and therefore incurs a funding charge applied to the new hedge rate.

Meet the Fund Solutions team



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