Silicon Valley Bank

SVB Global Fund Banking 4-point FX hedging checklist:

A structured approach to managing currency risk

Over the last few years, the low interest rate environment has enabled funds to successfully profile and attract international investors as LPs cast a wider net to meet their target returns. Simultaneously, the deployment of refined and specialised investment theses have seen funds identify geographically diverse opportunities which are not always denominated in the fund currency. As SVB's Global Fund Banking clients navigate these elements, a question regularly posed is

"How should foreign currency exposures be managed?"

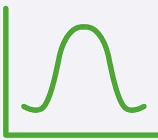
There is no one-size-fits-all answer. Whether it is prudent for a fund to hedge its currency risk is impacted by a range of factors, such as the asset type acquired and the relative size of the exposure. It may be useful to consider each fund or investment on its own merit.

> We have developed a four-point checklist to help assist clients as they evaluate this important strategic and risk-based decision. This checklist may be used and referenced during the pre-close analysis and due-diligence stage of all investments outside a funds denominated currency.

The FX hedging decision: SVB's Global Fund Banking 4-point checklist

Materiality:

How material is the potential loss from currency swings?

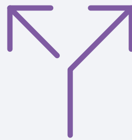


Likelihood of investment success:

What is the probability the deal will meet Internal Rate of Return goals?

Exit timing:

How much visibility and/or control do you have on the timing of the exit?



Nature of exit:

Is an FX transaction likely upon exit, due to the location of the IPO or operating currency of the acquirer?

Consider each item on the checklist in sequence to assess whether hedging the fund's currency risk is effective or efficient and is appropriate to the fund's overall objectives and risk appetite.

Materiality

Two primary factors determine the materiality of potential currency-related losses: the size of foreign currency holdings and the potential impact currency fluctuations could have on them.

To gauge how the size of foreign holdings affects their materiality, measure the percentage of the fund's net asset value made up of assets denominated in foreign currencies. To measure potential impact, consider the gain or loss that could result from moves in the foreign currency. This projection varies by currency; it can be based on historical patterns or currency option prices, and generally assigns a level of probability to projected outcomes.

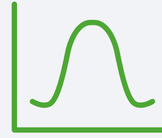
The combination of size and impact determines materiality. Consider the following hypothetical example:

> A $200 million fund invests $185 million in dollar-denominated assets and the remaining $15 million in euro-denominated assets. A 20% move in the euro—which would be large by historical standards—would have only a -1.5% impact on the fund's performance.[1]

The upshot: Even a large currency move would present a small potential loss, so currency risk management may be a low priority.

A fund may meet the materiality threshold when:

- both the size of a foreign-denominated position and the potential currency impact on performance are significant in their own right.
- the potential loss exceeds the fund's risk tolerance.



Likelihood of investment success

The odds that a given investment will pay off tend to be relatively low for venture capital funds, which typically generate their overall returns from a handful of highly successful investments. The uncertainty around an individual investment's likelihood of success can make it difficult for venture capital funds to hedge currency risk efficiently. The hedge contract must be supported with collateral and/or a credit facility at inception and settled with cash or currency at expiry, regardless of the investment performance. If the exposure fails to materialise, there is a potential for residual obligation on the hedge that would not be offset by the investment inflows.

Suppose a venture capital fund invests in 100 start-up technology companies, 90 in the US and 10 in Europe, and the fund expects 5 of the 100 to be successful. If its expectation is correct, and all firms have the same probability of success, the fund has about a 40% chance that at least one of its successful investments will be from Europe.[2] As a result, the fund has significant odds of exposure to the euro.

Many funds prefer to hold off on hedging currency until there is better visibility into the likelihood of investment success. If the fund intends to participate in subsequent funding rounds, it may want to wait to hedge at least until it has deployed the last dollar of capital. For funds that have some capital invested and more to come, un-hedged positions may help mitigate risk. For example, a fall in the euro would adversely affect the value of European assets already purchased, but also would improve the purchasing power of USD capital in subsequent rounds.

Considerations related to the likelihood of investment success are clearer for growth capital funds that invest in companies further along in their life cycle and for private equity firms investing in relatively mature companies. These funds historically have more certainty around future valuations than venture capital funds do, and greater visibility into exit timing as well. Funds of these types may support having greater certainty about whether FX exposure will materialise, making them better suited to active hedging strategies.

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Exit timing

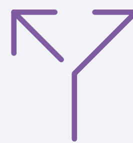
FX risk may arise at the point of investment where the required currency differs from that of the fund itself. Management of this can be deferred where a client has a multi-currency facility however, whether addressed up front or deferred, LPs will ultimately receive a capital call that will need conversion. Capital calls typically allow investors two weeks to make payment. In this period an adverse currency fluctuation could create risk that a fund does not draw sufficient capital to make the investment triggering a follow on capital call or a detrimental investment outcome. Alternatively a favourable market move could result in excess capital being drawn creating drag on the internal rate of return. Effective currency risk management can mitigate against these outcomes.

Funds that focus on seed, series A and series B investments may have little visibility into their exit timing. Conversely, later-stage investors, fund-of-funds investors and credit funds that lend directly to portfolio companies have greater line of sight into the timing of their exits.

Likewise, funds with a strong presence on a portfolio company's board have input and insight into both the type of exit and its timing. All else being equal, greater visibility into a potential exit may make hedging currency risk more viable. However, there are specific situations where it may also be appropriate to proceed with hedging despite exit date uncertainty.

Funds traditionally hedge currency risk using forward contracts. Forwards enable funds to lock in a predetermined rate at which foreign currency will be converted to the home currency a predetermined date. The forward represents an obligation to an amount and to a time.

Short-dated hedges can be used and rolled as needed. Purchased options may also be well-suited to deal with notional amount and timing uncertainties.



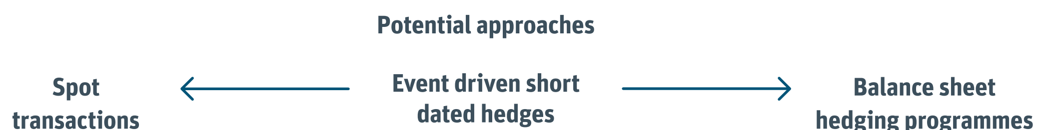
Nature of exit

Exits will take different forms according to the underlying investment. Private equity firms that purchase complete companies typically sell them in their entirety. This could mean being purchased by another private equity firm, being sold to industry or floating on the stock market, all of which may have a bearing on the currency realised by the fund. Likewise, a fund-of-funds investor that invests in a fund denominated in the British pound will be paid investment returns in GBP. By contrast, fund-backed international life science and biotech companies sometimes opt to exit via US IPOs, so the funds may receive their returns in USD, regardless of origin. Each outcome has differing degrees of certainty and may result in differing values being realised over which an investor may or may not have control. According to these variables differing approaches to currency fluctuations may be appropriate.

The bottom line

This table summarises how each type of fund might approach currency risk management.

	VC	Growth Capital / Private Equity	Fund of Funds	Credit
Materiality	Unlikely	Yes	Yes	Yes
Investment success	Uncertain	High	High	High
Exit timing	Uncertain	Uncertain	High	High
Nature of Exit	Uncertain	Typically known	Same currency	Same currency



Many venture capital firms tell us that they do not hedge their funds' currency risk at the investment stage. SVB generally agrees. As the checklist demonstrates, hedging the underlying asset currency exposure is very difficult for most venture capital firms to justify.

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The calculus is different for funds that invest in later-stage companies with higher valuations. Observations support that a much higher percentage of fund of funds investors and credit funds hedging their currency risk. The greater use of hedging is likely the appropriate path for these funds, considering the materiality of their currency risk, their likelihood of investment success, visibility into exiting timing, and the typical nature of their exits.

About Silicon Valley Bank's Global Fund Banking FX team

SVB's Global Fund Banking team focuses exclusively on fund banking and is supported by global FX professionals to help you with your international investments. You may utilise the SVB Global Fund Banking 4-point FX Hedging Checklist when looking for a structured approach to managing currency risk. We welcome you to leverage our Market Risk Solutions team as a resource when you assess the value proposition of international investments and the associated currency risks. We are here to help at any stage of the process, from the pre-close analysis and due-diligence stage all the way through closing and beyond.

Talk to us

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Risk statement

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[1] Calculation: [($15 million x -20%)/ $200m]

[2] Calculation: 1 – probability that all European companies fail = 1 - 0.95^104

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