

How the Strong Dollar Impacts Private Equity

David Snow, Privcap:

Hello, and welcome to Privcap. This is David Snow. I'm CEO and Co-Founder of Privcap, and today we have two experts who are going to help us understand a very important trend in the global economy and how that trend impacts the private equity asset class. And that is the strong dollar and how it impacts private equity, how it impacts with portfolio companies and also investor decisions.

I'm going to ask our two experts to briefly introduce themselves and their firms, and then we're going to get into a great interactive conversation. Why don't we start with Jason Thomas, Managing Director and Director of Research at The Carlisle Group?

Jason Thomas, The Carlisle Group:

Well thank you, and thank you very much for inviting me to participate today. I'm Jason Thomas. I'm the Director of Research at The Carlisle Group. Carlisle's a global alternative investment manager. We have just under \$200 billion of assets under management. My primary role at Carlisle is to analyze our portfolio of businesses. We have about 200 businesses in the portfolio, control positions in about 100. And I try to extract those data series from the portfolios looking at order books, inventories, occupancy rates to try to get a sense of the current state of the economy – its likely evolution in the short term. And I also advise the investment committees on macroeconomic issues, including foreign exchange.

Snow: And John Croyle, Partner and Head of the New York office for Premiere.

John Coyle, Premiere:

Great, thanks David and thank you as well for allowing me to participate. So John Croyle. As David said I'm a Partner, Head of our New York office and spend most of my time in the consumer sector. And Premiere, as many of you might know, is a private equity firm originally founded in Europe but today international with 11 offices around the globe. We've been in business for 30 years and have a particular focus on growth companies.

Snow: Great, well I'd like to remind the audience that this is going to be an interactive webinar so please think of some good questions for John and Jason. You can submit your questions at any time, but we will probably do most of the Q&A at the end of our conversation. Well why don't we get started. It's worth shoring just a few slides to really set the stage for the dramatic rise in the dollar versus other currencies. Here we see the U.S. dollar versus the Euro. The rise of the dollar has been even more remarkable in emerging markets like Brazil. Here's the Brazilian Real versus the dollar. And finally, here is the Yen versus the dollar.

So we'd love to hear from both of you what you think the most important ways that a stronger dollar has impacted private equity is, and will impact private equity. Maybe starting with John Coyle, as you look at your portfolio companies – whether it's new investment opportunities or existing portfolio companies – what are the most important ways that you think the rising dollar will impact your portfolio?

Coyle: Well, and the impact has been quick given how relatively the quick the rise of the dollar has been. But the most significant impact is on the underlying profitability of our international businesses. And so those with significant dollar expense bases have seen their profits decrease, particularly when they're selling in markets outside of the U.S. For instance, companies that would have exposures into the emerging world would see at least a 25% decline in the value of the revenue stream coming back to them in dollars. And meanwhile, their dollar expenses haven't changed. And so for U.S. businesses that have international revenue but don't have the international expenses to match that revenue, it's putting a lot of pressure on their profits.

Conversely of course, for European companies that are multi-national it's been a great benefit. And so you've seen a particular increase in quarterly profits for European companies as they enjoy their turn at a weakened currency. The United States multi-nationals had a nice run there for almost 15 years of declining U.S. dollar expenses, and now they have the chance for the Europeans to have that benefit with declining Euro expenses. So it's most significant for any companies that have a revenue stream that's outside of the U.S. but don't have an expense base to match it.

Snow: And Jason, you've got access to just a huge treasure trove of Carlisle portfolio companies around the world. What are you learning from that data with regard to currency fluctuations.

Thomas: Well I would agree with John, and I would separate the external sector – companies outside the United States – into those that are in advanced economies. Those in the Euro area – the UK, Japan – from those in

emerging market economies. And in the advanced economies, this has been a huge windfall. Profitability has been immense, and that's largely because these companies borrow in their own currencies, they invoice in their own currencies. So the increase in external revenue in domestic terms has increased profits.

Conversely, in many emerging market economies, you have companies that are funded in dollars and then many of their revenues are in domestic currencies. So there's an issue of a currency mismatch where instead of benefiting – as companies in advanced economies are enjoying the decline and the value of their domestic currency – many of these companies, because they have U.S. dollar liabilities, are under pressure. This is, in general, a phenomenon that I think could create attractive investment opportunities prospectively in that there could be companies that have to sell non-core assets to meet their dollar funding. And then are otherwise experiencing the equivalent of a debt overhang, where the USD value of their liabilities is too high relative to their domestic currency revenues. And as a consequence, they need to sell assets or otherwise find external finance to make up the gap.

Snow: Let's talk a bit more about new investment opportunities and how the rise of the dollar might have changed underwriting assumptions for private equity firms. John, are you seeing – whether it's in your firm or some other firms – a change in attitude about potential opportunities in Europe, or even in the emerging markets, where the dollar simply goes much further and now you're able to justify a slightly higher price for a target company that's denominated in a non-dollar currency?

Coyle: Yes, I'd say on the face of it – while it's not a primary reason to invest in a U.S. company or invest in a European company – there's no doubt that investors would see an ancillary benefit today of investing in Europe on the premise that they're likely going in closer to a Euro low than a Euro high. And depending on their time horizon relative to exit, by the time they exit they're likely to be off those lows. And so it's a second or a third way to get capital appreciation, knowing that you're going into it at a relatively low level.

It think the trick though, and the hard part about that, is that what on the surface might look like a European company may not in fact be a European company because you really have to get into a very detailed, analytical analysis of the company's cash flow to understand where those currency matches and mismatches are, as Jason was referring to. And understand whether they're net beneficiaries or a weak Euro or a strong Euro, and that's hard to do oftentimes from the outside in. And it's really only in a private equity perspective, in a process that allows you to get really to the bottom of the cash flows. And it's an exhaustive exercise to

look at currency inflows and outflows by business unit, by country, and understand are they net long or short Euro, net long or short dollar and where they stand relative to other currencies like the Yen, and then of course the emerging market basket.

But again, I think overall, people say I don't mind having more European exposure today than I did yesterday simply because, in all likelihood over time, the Euro will go back up. Not sure exactly how long, but if you'd have that premise it's often good to do that second level of analysis to make sure that the company you think is a European company is in fact low in the Euro.

Snow: Jason, what's your view on the extent to which currency levels should and are driving investment decisions? How does Carlisle approach the task that John just described of trying to figure out whether there is indeed an attractive discount on a Euro-denominated company instead of you're buying a company that actually has other currency exposures that washes away that discount?

Thomas: Well, I think in general one wants to stay out of this currency speculation realm. You want to buy good companies. You want to make them better, and you want to profit from an earnings growth that is generated during the course of the ownership. If there is an ancillary benefit from foreign exchange, that's great. Certainly you want to protect the investment from unwelcome movements in the currency, and think through the cash flows, where the costs come from, where revenues are, all the complicated calculations that John mentioned. But again, I think you want to stay out of the realm of currency speculation.

I would say that right now, I would agree with John that you have a cycle where it appears the dollar certainly strengthened massively from the end of Q2 2014 to the end of the first quarter of 2015. And since then, of course, has given back some of those gains. But it does seem that we're in a cycle where the dollar is likely to strengthen prospectively. The U.S. economy is just much further into the business cycle than the European economy – much different circumstance than many emerging market economies. So there is an expectation that over the next few years, the dollar is going to remain strong.

But again, when you're actually harvesting these investments, we could be at a very different point in the cycle where the dollar is actually starting to weaken or has weakened substantially relative to other major currencies. So an opinion about the likely gains from the currency over the course of an investment is very contingent on your expected holding period and that, of course, differs by investment, by the strategy that you pursuing.

Snow: John, maybe next question for you and it's a bit more of a further analysis around exposures to currencies that investors may not be aware that they actually have. Walk us through why it is that a U.S.-based investor who is primarily or entirely investing in dollar denominated funds and primarily investing in the U.S. – what does that investor need to understand about exposures that that private equity portfolio actually has to other currencies and to currency fluctuation that he or she might not be aware of?

Coyle: Sure, and I'm sure Carlisle does this to a great extent as well, but really the key is to look at the underlying investments and understand the aggregate level of revenue exposure by country. And so in the case of Premiere, for instance, as a firm that has a European heritage and certainly that remains our largest base of operations. Many people would say Premiere, a European firm, therefore they'll benefit from the Euro. But when we add up all our companies – over 30 of them – only about 40% of our underlying revenues in Europe, another 30 would be in North America and then the final 30 is rest of the world. And so breaking down that revenue into its piece is really key because many of us – certainly Carlisle and Premiere – are not investing in companies that are 100% domestic. More often than not, they have international operations. And so what from the outside looks like a very U.S. company, once you get inside you'll realize that it's probably a more complicated answer in terms of what the underlying currency exposures are.

Snow: Jason, do you participate in due diligence into companies that Carlisle may or may not buy and can you talk about the kind of due diligence that focuses on currency exposures?

Thomas: Sure. Well I spend a lot of time thinking about currency exposures and where the bilateral exchange rate is likely to go. But again, thinking where the costs of the business are actually denominated – you could be a European company and you could have a major U.S. supplier. You could have most of your revenues in pounds even though you're a Euro-denominated company. You could have revenues that are spread across the globe, even as your supply chain is domestic. So there are very many different situations that need to be thought through, and buying a U.S. company – people are very often of the view that the dollar is strong therefore the fair value of my U.S. investment should be higher. But in fact, those businesses that have global sales – perhaps 50% or more of sales and earning attributed to a business outside the United States, could actually suffer. Whereas a business in business in Japan, for example, benefitting from a weak Yen seeing its profits grow to such a degree that the increase in the fair value of the business actually exceeds any decline

that the investor experiences from investing in a Yen-denominated business.

So I think that there are, in addition to looking at through the costs, revenues and the complexity of global supply chains, there's also a need to look at the elasticities. And some companies are very, very sensitive in terms of profits, and in terms of in gross sales, to currency fluctuations in ways that others aren't. And you think of suppliers, producers of intermediate goods, where currency fluctuation – particularly in the magnitude that we've witnessed – can lead to a lot of effort on the part of managers to try to better align costs, look for other ways to source things in Europe or Japan – other places where there has been a substantial decline in the foreign exchange rate.

So again, I think it's looking at the complexity of the supply chain, the revenues, but then also just the sensitivities. Is it a luxury goods manufacturer or is it a producer of a differentiated product such that a movement in foreign exchange are not going to have so great an impact on demand or market share. That's a very different circumstance, again, from a commodity producer or a producer of intermediate goods where it's relatively easy to switch a response to a sizeable move in the exchange rate.

Snow: I'd like to talk a bit about the emerging markets. And Jason, given Carlisle's activities in the emerging markets maybe we can structure this as a follow-up question for you, but certainly want to hear John's point of view as well. But given how much more dramatically the dollar has strengthened in places like Brazil, what kind of an impact is that going to have on the flow of capital to and from the private equity markets there?

Thomas: Well, I think that the way that I would describe it is that there was a push and a pull to emerging markets. And the push came from the Fed and central banks that reduced rates of return domestically and pushed investors into diversifying into emerging markets. That led to very rapid fund flows in emerging markets, very rapid gains in emerging market valuations and asset prices. And it led to a 2010, 2011 period where things started to look a little frothy. But there was also a pull from emerging markets, and that is just the demographics and the potential growth rates that exist.

And I think that in many of these countries and many of these economies, you have cycles where things are never as good as they appear and things are never as bad as they appear on the downside either. And in places like Brazil for example, there you have a really quite large adjustment in the currency and in asset prices, you start to get the sense that assets are priced for something much worse than is actually occurring. If there's

increases in interest rates necessary to choke off domestic inflation, which is occurring, the central bank continues to increase interest rates at 13.75% - very, very high, but willing to take the short-term pain to stabilize the currency. If the political authorities agree to a sizable fiscal adjustment, as they have and implement it, you have a sense that there's going to be 2016, 2017 where things look a lot brighter than they do today.

I think that the same dynamics can be said elsewhere in the emerging markets as well. So again, I think it's a situation where thinking through current conditions, trying to get a sense of 2016, 2017, 2018 actually makes some of these markets look more attractive than they may on their surface given the very difficult economic conditions.

Snow: John, is there a Premiere view of the emerging markets? I mean, how exposed are your portfolio companies to either sales or other activities there?

Coyle: Well I'd bifurcate the question into two beds. I think fundamentally, we as a firm are huge believers in the emerging market opportunity. And it was only a couple of years ago that it was all the rage with bricks and everything else. And if you look at the characteristics of those markets in terms of population growth, if you look at it in terms of building of the middle class, if you look at it in terms of education rates, the consumer markets there you can get very excited. However, at the moment you have a technical problem, which as Jason described, is flight of capital out of there. As interest rates in the U.S., who needs to invest into to Real at the moment. And so fundamentally, I think the opportunity in the emerging market has never been better. But as a technical matter, you have some headwinds to deal with.

I think you also then have to look at it by industry, and so we've been very big investors in the agricultural space. Brazil is the largest AG market in the world. And it's a core strength of the Brazilian economy, and that market is not going away. And in fact, they're benefiting right now from the cheaper Real. So that's an area that we are very bullish on. We'll continue to look to invest. There is no doubt that it's a harder place today - particularly when it comes to the value of their currencies. They just don't have that buying power to spend on luxury items and that's why you're seeing a trade-off in the performance of luxury companies in the emerging worlds. On top of it, of course, you have political considerations in places like China getting away from the gift giving. But we're still very bullish on it.

I don't know, and certainly we don't get paid for currency speculation either, but being a student of history looking at the last two bull markets

for the U.S. dollar – it was five years back in the 80s and seven years in the '95 to 2002 period. So I think that the odd-on bet, in certainly our view, is that this strong U.S. dollar phenomenon is here to stay for a number of years. And therefore, you have to price that in to your returns when you're looking at investments. You have to assume that you'll be looking at depreciated currencies in the rapidly developing economies for at least several years. And therefore, we should price that into our returns.

Snow: I have one more question for both of you and then I'd like to throw questions over to our audience. But while I ask the question, I'd like to remind our audience that they can send in questions anonymously. So please send them in now and we'll get to them after this next topic. But it has to do with currency hedges. There are a number of products available to hedge your investments on the currency side. Do either of your firms use them, and if so, why or why not – maybe starting with John Coyle.

Coyle: Sure. So it's a multi-level answer. At the fund level, we don't do any currency hedging and that's simply because of the unpredictability of when we're going to exit. And of course, the most expensive aspect of an option is time and the time is very difficult to judge. And then two, just generally speaking, the price of hedging is extraordinarily high versus the perceived benefit.

What we do do though is hedge at many other levels. So first is, if we're buying a non-Euro business the day we announce the investment, we also immediately go and buy a hedge so that we know exactly how much Euros will be required to pay a non-Euro price. So if we're buying a business in the U.S. for a billion dollars, we'll immediately go and buy a billion dollars of currency so that we know what the price is at the day we announce the deal.

Two is then, at the company level we try really hard to make sure the debt is placed in a place that makes sense for the business. So if you have a business that's in the U.S. but with a big Euro component of revenue but not a big Euro component of expense, we will then go and issue some of the debt in Euros to create a hedge there such that will give better alignment between our revenues and expenses. Too then, the companies at an operational level are constantly hedging and for the most part, they're hedging their expected receivables coming in. So we have a policy in general that they'll hedge 50% of their expected revenue over a six-month period, and then they hedge 100% typically when they transact. So when they invoice.

And the other thing we don't do, and I don't think many people do, is we don't hedge the translation risk. So even if we have a business that's

perfectly matched in Brazil with Brazil revenue and Brazil expenses, of course when it goes to convert that Brazil EBITA back to dollars, it's going to be worth 25% less. We don't hedge that. We just take the pain in terms of the profit loss statement. So really focused in operationally with the companies both through natural means through operational hedges and then making sure that we can at least put the debt in a place that makes sense relative to the revenue.

Snow: Jason, what's the policy at Carlisle?

Thomas: Well it differs depending on the fund and its denomination. But most of the attention and time relates to the portfolio companies similar to the way that John described. One point I would just make about options. I think there's a general sense that investors can tolerate, or management at the portfolio company can tolerate, 3% to 5% moves either way. That they're not looking to inflate the company against that, but are worried about the larger moves as we've seen. And as of June 30, 2014 the cost of buying an option on Euro USD in terms of implied volatility hit an all-time low.

So interesting, it was never cheaper in the history of the Euro – since 1999 – to hedge Euro assets or Euro exposure than it was just before you had the largest depreciation in the history of the Euro. And I think that this is really instructive for investors because now given the pain that's been experienced over the last nine months to a year, that there's much greater sensitivity to movements in foreign exchange. And as a consequence, the cost of options measured again in implied volatility, has surged. And so it's something to keep in mind that the movements don't necessarily correlate to the price protection. In some cases, the movement can be as large as it is because so few people are hedged. Conversely, the move for technical factors in an exchange rate can actually be more muted when market participants are actually quite hedged against a large movement.

So paying up for protection today, in some cases, could be like driving using the rear view mirror. And again, it's not to say that people shouldn't be focused on this or concerned. But again, just to recognize that the cost of hedges very often reflects the damage that occurred on a retrospective basis as opposed to being forward looking.

Finally I would just say that there are lots of ways to generate natural hedges through the liability structure of the business. John made allusion to this, but if you have a business whose funding is perfectly matched with liabilities, you're going to be very, very well positioned. And the need to then layer on top of that additional hedges via swaps, options or forwards is greatly lessened. And so I think that thinking about those

natural hedges – staggering purchase, staggering exits so you have liquidity at different dates – those natural hedges I think are much more efficient. And again, lessen the need for layering derivatives on top.

Snow: Okay we got a great question from an audience member here, and it is what factors would you look for that could make this strong dollar period either longer or shorter than the “typical” five to seven year time frame? I’ll throw that out to either of you. Again, we won’t hold you to your macroeconomic predictions, but would love to hear what you think nonetheless. John, what do you think would either extend or shorten this strong dollar period?

Coyle: So I will draw on my economics major from undergrad as my last practicing view on FX, but I would say what’ll make it longer is simply Europe and the emerging world struggling for growth for a longer period of time. So you have a prolonged period of no growth, low growth, no inflation and therefore incredibly low interest rate environment for a prolonged period of time – generational aspect. And therefore, the dollar stays strong and these other currencies remain weak.

Snow: What’s your view, Jason, on factors that could either lengthen or shorten the strong-dollar era?

Thomas: Well I think that with respect to lengthening it, it’s just how the U.S. economy responds to rate hikes. Again as I mentioned earlier, the U.S. is much, much further in the cycle than Europe – much different current economic conditions than most of the emerging world. So when the rate hike cycle starts – presumably the fourth quarter of this year – how is the economy going to react to it? If it’s a non-event, there’s likely to be some volatility in bond markets and the like. But if it’s a non-event for the economy and we continue to see trend growth of 2.25%, 2.5% and the side continues hiking, I think you could actually have a fairly long cycle.

On the flip side, one of the interesting dynamics of the Euro has been the way that it’s strengthened each time there’s been a – there’s been lots of relief rallies. When the ECB launched the securities market program after the initial Greek crisis in 2010, the Euro surged. So you have a central bank that is actually accommodating – expanding – its balance sheet. Normally you’d think the currency depreciates, but in fact it rallied. The same thing happened with Draghi’s whatever-it-takes speech in July of 2012, and the outright monetary transaction. Here’s a central bank easing policy, but yet its currency actually surged.

And then today, I think that as you see the risk of deflation abate and you see some life in the European economy – it grew at 1.6% annual rate in the first quarter – the performance since April has of course been very

strong, the Euro moving from 104.5 up to a peak of 114.5. So I think the people that look at Europe or Japan as one-way bets, it's been interesting the extent to which these currencies rally on the back of good news. And should Europe see growth accelerate from current trend of 1% to 1.5% to in the neighborhood of 2%, you could actually have a much stronger Euro than many people are contemplating.

Snow: Well here's a question then – it's a little bit forward-looking – then I think we can wrap things up. And the question is – and for both of you – however long the strong period is, and without necessarily talking about your own portfolio companies, what types of companies are positioned to win in a strong-dollar environment and what types of investments are positioned to lose or to struggle? If you could characterize both the winners and the losers, maybe starting with John.

Coyle: I think the winners will be European companies, by and large. I think it's a reasonable bet that you will see the Euro closer to parity than the 140 level where it's traded. And remember that it was struck much closer to parity than where it's traded through its history. And therefore, those that are multi-national will be well-positioned. Plus you have the fact that there's still a good supply of labor here and therefore, from a competitive wage perspective, I think it will be a competitive market.

I'm worried a little bit about the emerging markets. If it's longer and more deep than people assume, because they will have a funding problem. They have high infrastructure needs. They need to attract external capital and so from a revenue perspective, it could be a rougher go. So companies selling into emerging markets – if this is prolonged, generation where the emerging markets simply can't attract capital cause there's more on a risk-adjusted basis, more attractive capital opportunities elsewhere. I'd be a little bit worried about assuming big revenue increases in emerging markets. Again, you'll go find pockets of industry – ag being one that I talked about, food supply – that will probably do well regardless. But as a general matter, I'd be a little bit more concerned about assuming bigger revenue increases in the emerging markets.

Snow: Jason, what's your view on winners and loser in a strong dollar cycle?

Thomas: I would keep a close eye on China. It's been interesting to see the Renminbi maintain largely its de facto peg to the dollar. I think that that's largely because of the priority that the political establishment has made in achieving reserve currency status through the STR basket at the IMF. But when you look at the CNY relative to trading partners, it looks extremely strong. There's been a 20% appreciation relative to the Yen, a 20% appreciation relative to the Aussie dollar, 10% appreciation against the Korean Yuan. This is certainly impacting the competitiveness of a lot

of Chinese businesses, manufacturers and should the dollar strengthen and should the Renminbi maintain rough parity to the dollar, you could have some difficulties there.

I agree wholeheartedly, if the Euro goes down to parity or if it flirts with the 2002 lows of 88 cents, you're going to have extraordinarily strong earnings growth in Europe. Not just in Germany, but French businesses, Italian exporters. Right now, it looks as though earnings are going to grow to about 14% in the Euro area this year because of the currency weakness. You have very large market share edge for European businesses relative to U.S. businesses across the globe – especially in emerging markets. And the profits derived from those sales could increase. You could also have expansion of market share as the Euro weakens further relative to the U.S. dollar. So again, if you specify that the Euro is going to go to parity or not increase from these levels, I think that the earnings power – the potential margin expansion of European businesses – makes it a very, very attractive place to invest.

Snow: Great, well this has been a fascinating conversation. And obviously it's a big topic, but I think we should wrap it up for now. I'd like to thank both Jason Thomas and John Coyle for sharing their expertise with us today. This webinar will be available on playback mode, and we will also be producing a transcript article based on this conversation that will be distributed to the global Privcap audience. But in the meantime, we'd like to thank both of you again, thank the audience for being part of this and have a great rest of your day.

Coyle: Thanks, David. Thanks, Jason.

Thomas: Thank you.