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WEBINAR

Briefing

The Rise of the U.S. Dollar and Global PE

From the Privcap webinar:
"How the Strong Dollar Impacts Private Equity"

John Coyle
Permira

Jason Thomas
The Carlyle Group

How the **Strong Dollar** Impacts **Private Equity**

The rise of the U.S. dollar has far-reaching implications for the global economy as well as for the private equity market. Privcap speaks with experts from Permira and The Carlyle Group about these implications, how currency fluctuations affect investment decisions, and how to work with funds with different currency denominations.

The Panelists

John Coyle
Partner,
Permira

➜ BIO

Coyle is head of the firm's New York office. He is a member of the financing group and has worked on a number of transactions, including Arysta LifeScience, BakerCorp, Renaissance Learning, and Atrium Innovations Inc. Prior to joining Permira in 2008, Coyle was the global head of the financial sponsor group at J.P. Morgan Securities.

Jason Thomas
Managing Director and Director of Research,
The Carlyle Group

➜ BIO

Thomas focuses on economic and statistical analysis of the Carlyle portfolio, asset prices, and broader trends in the global economy. His research helps to identify new investment opportunities, advance strategic initiatives and corporate development, and support Carlyle investors. Previously, Thomas was vice president of research at the Private Equity Council.

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David Snow, Privcap: What are the most important ways that a stronger dollar has impacted private equity and your portfolio?

John Coyle, Permira: The most significant impact is on the underlying profitability of our international businesses. 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 percent decline in the value of the revenue stream coming back to them in dollars. Meanwhile, their dollar expenses haven't changed. 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, for European companies that are multinational, it's been a great benefit. You've seen a particular increase in quarterly profits for European companies as they enjoy their turn at a weakened currency.

Jason, you have access to a huge treasure trove of Carlyle portfolio companies around the world. What are you learning from that data with regard to currency fluctuations?

Jason Thomas, The Carlyle Group: I would separate the external sector—companies outside the United States—into those that are in advanced economies and those in emerging-market economies. In the advanced economies, this has been a huge windfall. Profitability has been immense, and that's largely because these companies borrow and 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 their revenues are in domestic currencies. 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. 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 U.S. dollar value of their liabilities is too high relative to their domestic currency revenues. As a consequence, they need to sell assets or otherwise find external financing to make up the gap.

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>
> –John Coyle, Permira

What does a U.S.-based investor working with dollar-denominated funds need to understand about currency fluctuation?

Coyle: The key is to look at the underlying investments and understand the aggregate level of revenue exposure by country. Many people would say Permira, a European firm, would benefit from the euro. But when we add up all our companies—over 30 of them—only about 40 percent of our underlying revenues are in Europe, another 30 [percent] would be in North America, and then the final 30 [percent] is in the rest of the world.

Jason, can you talk about the kind of due diligence that focuses on currency exposures that occurs [that occur?] when Carlyle looks into buying companies?

Thomas: I spend a lot of time thinking about currency exposure and where the bilateral exchange rate is likely to go. People are very often of the view that the dollar is strong and therefore the fair value of my U.S. investment should be higher. But in fact, those businesses that have global sales could actually suffer.

There's also a need to look at the elasticities. Some companies are very sensitive in terms of profits and gross sales to currency fluctuations in ways that others aren't. You think of suppliers— where currency fluctuation can lead to a lot of effort on the part of managers to try to better align costs— and look for other ways to source things in other places where there has been a substantial decline in the foreign exchange rate, like Europe or Japan.

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>
> –Jason Thomas, The Carlyle Group

Given how 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: There was a push and a pull to emerging markets. The Fed and central banks reduced rates of return domestically and pushed investors into diversifying into emerging markets. That led to very rapid gains in emerging-market valuations and asset prices. There was also a pull from emerging markets, and that is just the demographics and the potential growth rates that exist.

In many of these countries and economies, you have cycles where things are never as good or bad as they appear. In places like Brazil, for example, you have a quite large adjustment in the currency and in asset prices, and you start to get the sense that assets are priced for something much worse than is actually occurring. If there are increases in interest rates necessary to choke off domestic inflation, which is occurring, the central bank continues to increase interest rates at 13.75 percent—very high, but willing to take the short-term pain to stabilize the currency. If the political authorities agree to a sizable fiscal adjustment, you have a sense that in 2016, 2017, things will look a lot brighter than they do today.

John, how exposed are your portfolio companies to either sales or other activities in emerging markets?

Coyle: Fundamentally, we as a firm are huge believers in the emerging-market opportunity. If you look at the characteristics of those markets in terms of population growth, building the middle class, education rates, the consumer markets there, you can get very excited. However, at the moment you have a technical problem, which is a flight of capital out of there.

The odds-on bet is that this strong U.S. dollar phenomenon is here to stay for a number of years. You have to assume that you'll be looking at depreciated currencies in the rapidly developing economies for several years or more, and therefore we should price that into our returns.

There are a number of products available to hedge your investments on the currency side. Do either of your firms use them?

Coyle: 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. Of course, the most expensive aspect of an option is time, and the time is very difficult to judge. And the price of hedging is extraordinarily high versus the perceived benefit.

What we do, though, is hedge at many other levels. 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 in euros will be required to pay a non-euro price.

Jason, what's the policy at Carlyle?

Thomas: It differs, depending on the fund and its denomination. Most of the attention and time relates to the portfolio companies. There's a general sense that investors can tolerate 3 percent to 5 percent moves either way—they're not looking to inflate the company against that, but are worried about the larger moves we've seen.

Now there's much greater sensitivity to movements in foreign exchange. As a consequence, the cost of options measured in implied volatility has surged. 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 hedged against a large movement.

Finally, I would say that there are lots of ways to generate natural hedges through the liability structure of the business. If you have a business whose funding is perfectly matched with liabilities, you're going to be very well positioned. The need to then layer, on top of that, additional hedges via swaps, options, or forwards is greatly lessened. Those natural hedges—staggering purchases, staggering exits, so you have liquidity at different dates—are much more efficient. ■

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