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Lowering risk and saving money?

A CFO's roadmap for foreign currency debt issuance

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1. Lowering currency exposure—cheaper and easier

Large global companies have become more exposed to non-home currencies over the last few decades.[1] **For example, large U.S. firms now generate 30% of their revenues outside the U.S. versus 20% just one decade ago.**[2] In many cases, firms have more than doubled their exposure to foreign currencies. With this increased non-domestic exposure comes various challenges, not the least of which is foreign currency exposure.

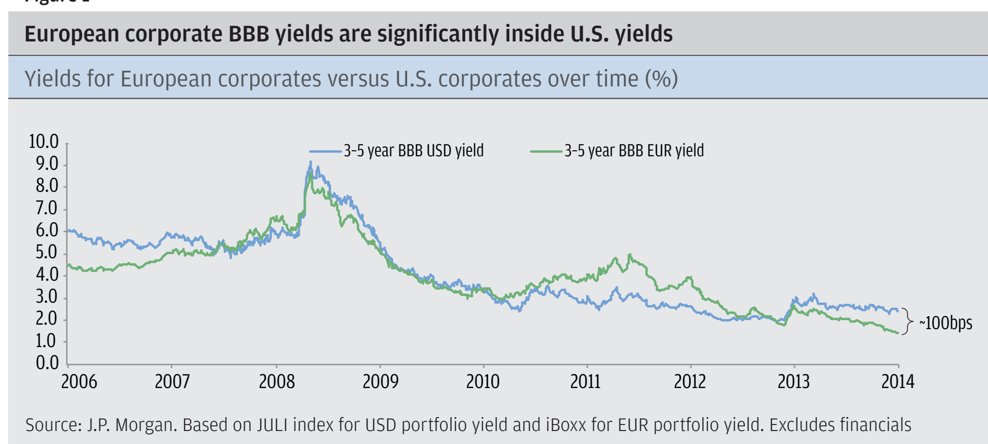
For decades, academics have extolled the virtues of **hedging long-term economic foreign currency risk by issuing debt in the same currency.**[3] While perfect in concept, such hedging has been implemented on a materially smaller scale than theory would dictate, especially for U.S. multinationals. Two reasons explain this discrepancy. First, many firms are reluctant to issue debt in a foreign currency when interest payments in the foreign currency are higher than USD interest payments. Second, the accounting treatment of non-home currency debt is not always issuer-friendly. In sum, **the benefits of hedging are longer term, through reduced volatility, whereas the costs of hedging (i.e., paying higher interest) are immediate, affecting all-important EPS targets.**

One foreign currency, the Euro, can demonstrate today's benefits of foreign debt issuance to U.S. companies with EUR exposure. For the large majority of global U.S. firms with EUR exposure, there has been a dramatic change in the economics of hedging. As illustrated in Figure 1, issuing in EUR was a little over 100bps more expensive (than issuing in USD) in 2011, whereas it is about 100bps less expensive today. In other words, **a global U.S. firm can lower its currency risk and at the same time improve its EPS by issuing EUR debt.**

Figure 1

European corporate BBB yields are significantly inside U.S. yields

Yields for European corporates versus U.S. corporates over time (%)



Source: J.P. Morgan. Based on JULI index for USD portfolio yield and iBoxx for EUR portfolio yield. Excludes financials

In this report, we use the Euro as a template to discuss recent developments in foreign issuance. We also provide a decision-making framework to guide executives as they re-examine their financial policies. As noted, this report focuses on Euro issuance opportunities for U.S. firms, but the thought process we describe is, however, also useful to global companies with other home currencies and other exposures.

[1] For further reading on U.S. companies' increasing exposure to foreign currency, please see our July 2013 report, "Foreign exchange curveballs: Capitalizing on paradigm currency shifts," and our October 2012 report, "Riding the foreign exchange roller coaster: Corporate finance implications of a riskier currency environment." They are located at: http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_ForeignExchangeCurveballs.pdf and http://www.jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_RiskierCurrencyEnvironment.pdf, respectively

[2] Includes current S&P 500 members, excluding financials

[3] All references herein to the issuance of debt in foreign currency include both organic debt issuances as well as synthetic issuances achieved via cross-currency swaps

EXECUTIVE TAKEAWAY

Traditionally, U.S. firms seeking to reduce economic currency exposure by issuing EUR debt faced higher interest costs and hence reduced EPS. Today, the tables have turned, with USD-based firms able to both hedge their long-term EUR exposure and increase their EPS via lower EUR issuance costs. Firms with EUR exposures should carefully re-examine EUR issuance prospects in this context.

2. Currency exposure

U.S. firms with global operations, and often even those without global operations, face foreign currency risk. Currency exposures mentioned in this report encompass the three broad categories of currency exposure:

- **Transaction exposure:** Cash flow and earnings volatility coming from booked or forecasted foreign currency denominated revenues, expenses, and financing, such as receivables, payables and related transactions that will take place in the future
- **Translation exposure:** Balance sheet volatility coming from the end of reporting period currency translation of a foreign subsidiary's balance sheet (net investment) or income statement
- **Economic exposure:** Economic currency exposure is a more general term, which includes the risks previously noted, but also includes indirect threats (e.g., economic risk to foreign currency fluctuations through competition against firms that have different currency exposures)

EXECUTIVE TAKEAWAY

Issuing debt to match the currency of both cash inflow and long-term economic value can help reduce transaction, translation and economic exposure.

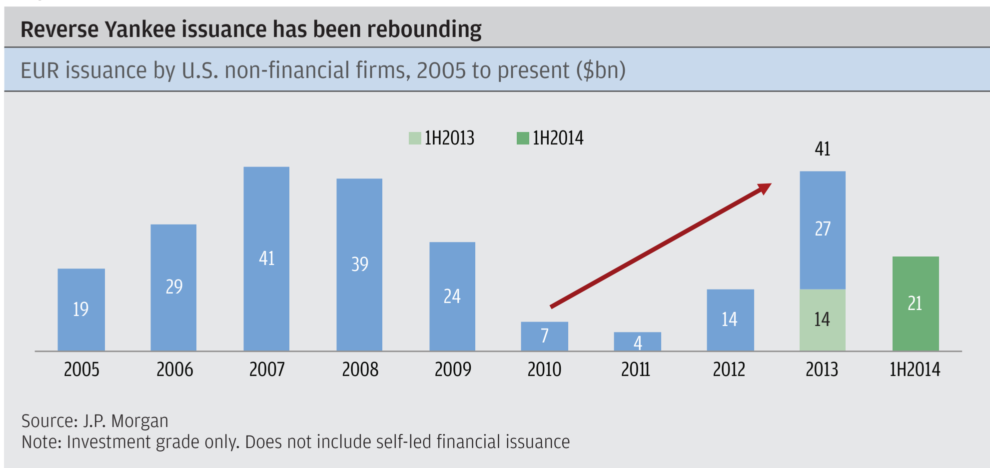
3. Firms are taking notice, with growing EUR issuance by global U.S. firms

The last 18 months have been marked by a notable increase in U.S. firms issuing in EUR (henceforth "reverse Yankee"). The volume of EUR debt issuance by U.S. multinationals has almost ***tripled*** from 2012 to 2013. Moreover, in the first half of 2014, reverse Yankee issuance has already exceeded that of the comparable 2013 period by 50%, suggesting that the trend of U.S. multinationals accessing EUR markets is still accelerating (see Figure 2). Note that Figure 2 also includes U.S. firms that require USD funding, but issue EUR debt and swap back to USD.

Figure 2

Reverse Yankee issuance has been rebounding

EUR issuance by U.S. non-financial firms, 2005 to present ($bn)



Source: J.P. Morgan
Note: Investment grade only. Does not include self-led financial issuance

Although various factors continue to contribute to this rebound in reverse Yankee issuance, the most important is the more **favorable pricing** available to EUR issuers, compared to the USD, as already discussed in Section 1 of this report. In this light, frequent issuers, as well as firms who are re-examining their debt portfolio, should consider whether they can unlock value by seizing opportunities from beneficial pricing in the EUR market.

Another meaningful contributor to this trend is the **rise in M&A activity.** Global M&A volume to date in 2014 is up from $1.3 trillion to $1.8 trillion on a year-over-year basis, 43% versus 34% of these transactions are cross-border.[4] If debt is used to finance some or all of the acquisition, then companies now have a unique opportunity to reassess whether their liability mix is optimal relative to their asset mix. In addition, the trend of using leverage to increase shareholder distributions and reduce risk of shareholder activism can dovetail with a discussion of which currency in which to issue debt.

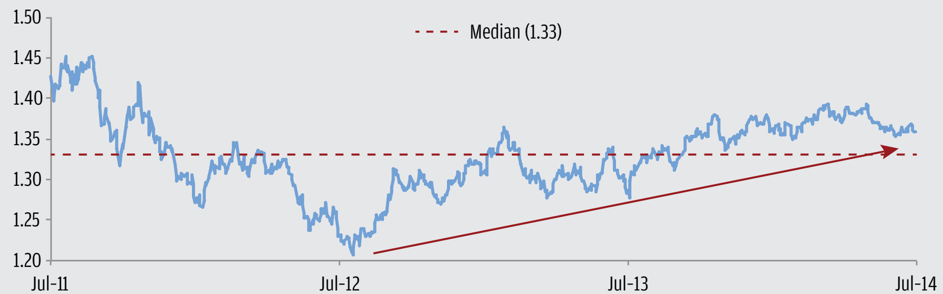
Finally, while the USD per EUR exchange rate remains near its three-year median level, **the EUR has strengthened considerably against the USD over the past two years** (see Figure 3). While the current spot rate should be irrelevant for firms that decide to hedge their currency exposure, many firms do consider the entry point to be important. Some firms would be reluctant, for example, to establish a hedge position when the EUR is particularly weak.

[4] Source: J.P. Morgan, Dealogic

Figure 3

The USD per EUR spot rate is around its three-year-running median level

USD per EUR rate over time



Source: J.P. Morgan

Summary of non-currency risk-related benefits of issuing EUR debt for U.S. companies

- **Investor diversification:** For U.S. issuers with a large outstanding stock of USD debt, incremental USD issuance can put pressure on their existing spreads. This pressure could be alleviated by issuing in another currency in which an issuer is relatively "undersupplied"

- **Improving credit spreads:** Funding in EUR debt markets has become more competitive relative to USD as the credit environment has improved and EUR/USD cross-currency basis has normalized

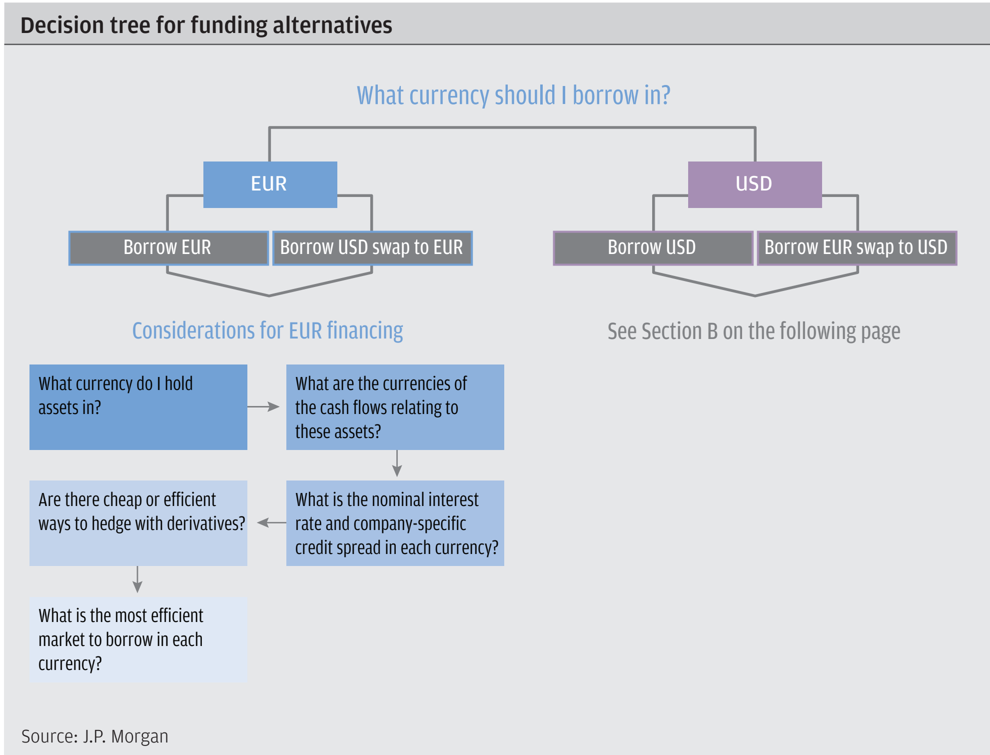
- **Liability profile management:** The option of tenors available in the U.S. corporate bond market is most often limited to the specific benchmark Treasuries (2, 3, 5, 10 and 30 years). By contrast, Euro denominated bonds are marketed over the continuous Euro swaps curve allowing issuers much greater flexibility in issuing "off-the-run" maturities such as 7-, 8-, 9-, 11-, 12-, 13-, 14-, 15- or 20-year maturities

4. Execution considerations

As mentioned in Section 3, firms access the EUR debt market because they require EUR funding, or because they require USD funding where issuing EUR debt and swapping back to USD is more efficient. Figure 4 outlines the issues to consider when evaluating funding needs.

Figure 4

Decision tree for funding alternatives



Source: J.P. Morgan

Section A: EUR financing needs: Organic or Synthetic

Once a decision is made to borrow EUR, the following questions can arise:

- Should a company issue in EUR ("organic debt") or issue in the U.S. corporate bond market and swap to EUR ("synthetic debt")?
  - If the company is able to issue in USD or EUR, how should it compare organic debt pricing to synthetic debt pricing?
- Where should the debt (regardless of whether organic or synthetic) be located (parent or sub)?
  - Is it more efficient to borrow at the parent and lend intercompany to the sub (or contribute the loan proceeds as equity to the sub), or
  - Can the sub borrow directly (which may raise parent guarantee considerations)?

Leverage risk of foreign currency issuance

As spot currency rates move over the life of a debt issuance, the USD-equivalent leverage of EUR debt will fluctuate. Firms tend to worry about EUR appreciation and whether EUR debt is worth more now in USD terms versus at inception. Since this debt has been issued as a hedge of real cash or earnings exposure, the value of the EUR asset/cash flow should now also be higher. Despite being an appropriate economic hedge, foreign denominated debt has an impact on credit ratios. Companies should consider the materiality of potential higher leverage to the extent that the EUR appreciates.

Liquidity risk of foreign currency issuance

Similar to the leverage implications previously discussed, if the EUR is stronger at the time of the debt maturity (versus the issuance date), companies might have cash flow implications related to debt repayment. If a company decides to refinance maturing EUR debt with new EUR debt, the cash flow implications are largely eliminated. If the EUR is stronger and a company decides to refinance maturing EUR debt with USD debt, then the company may face a cash shortage. Even though the value of the company's EUR assets should have increased by as much as the increase in the value of the debt (in USD terms), the debt repayment requires liquidity that the EUR assets may not provide. Additional considerations could arise if the EUR debt was created synthetically through a swap, since there could be a derivative settlement required at maturity. While the optics of a cash-settled derivative is a consideration, we note that the liquidity implications of a stronger EUR at maturity would be identical for both organic and synthetic debt.

Section B: Considerations when a cross-currency swap is involved

Figure 5

USD per EUR currency basis has normalized

USD per EUR currency basis over time

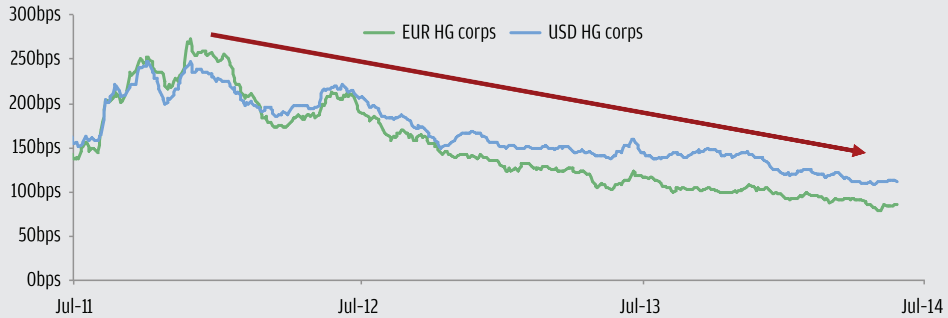
Source: J.P. Morgan

Anytime an issuer is swapping debt from one currency to another (from EUR to USD or from USD to EUR) the level of the currency basis will be an important factor. Currency basis reflects the relative supply/demand for funding in one currency versus another. While in a normal market USD versus EUR currency basis should trade closer to zero, in times of severe distress, it may trade sharply negative (as the global demand for USD funding will likely increase). This is exactly what happened during the European sovereign debt crisis; however, after ECB President Draghi's summer 2012 pledge to "do whatever it takes" to stabilize the Eurozone, USD versus EUR currency basis began to normalize and subsequently moved back toward zero (see Figure 5). Over the same period, EUR credit spreads have also narrowed materially relative to USD spreads (see Figure 6).

Figure 6

EUR spreads have outperformed USD spreads

HG corporate spreads over time



Source: J.P. Morgan DataQuery; ASW spread of iBoxx corps € bonds and the ASW spread of $ corporate bonds in the JULI index

Given the improvement in both EUR currency basis and EUR credit spreads (versus USD) over the past two years, many U.S. multinationals have issued debt in Europe even when they have no specific EUR requirements and swapped the proceeds back to USD. Improved conditions in EUR funding markets have allowed U.S. multinationals to both take advantage of pricing efficiencies and diversify their investor base. In particular, frequent USD issuers should consider pricing break-evens across the EUR curve relative to USD, which can contribute to a more robust and overall lower cost of funding.

EXECUTIVE TAKEAWAY

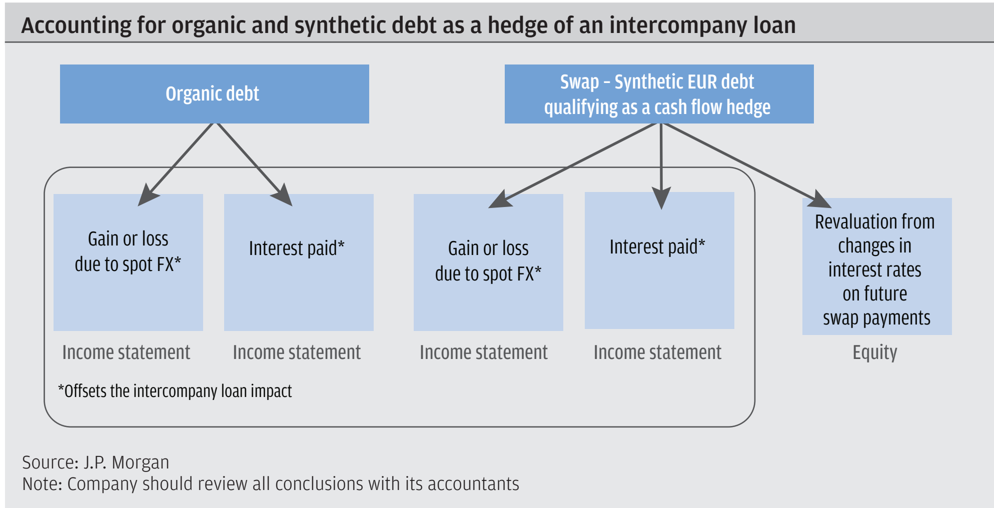
Firms that seek to hedge with foreign currency debt can issue organic foreign currency debt or issue USD debt and swap it to the foreign currency. Alternatively, firms that desire USD funding may find economic efficiencies in borrowing EUR and swapping to USD. Firms should be mindful of leverage and liquidity considerations related to foreign currency issuance.

5. Accounting considerations

Organic or synthetic foreign currency debt can be an **"accounting hedge"** of either an intercompany loan (see Figure 7) or a net investment exposure (see Figure 8). For example, the change in the USD value of a EUR intercompany loan receivable at the parent will impact current earnings. Either organic or synthetic debt will provide an exact earnings offset for this exposure (with hedge accounting applied to the swap when synthetic debt is employed).

Figure 7

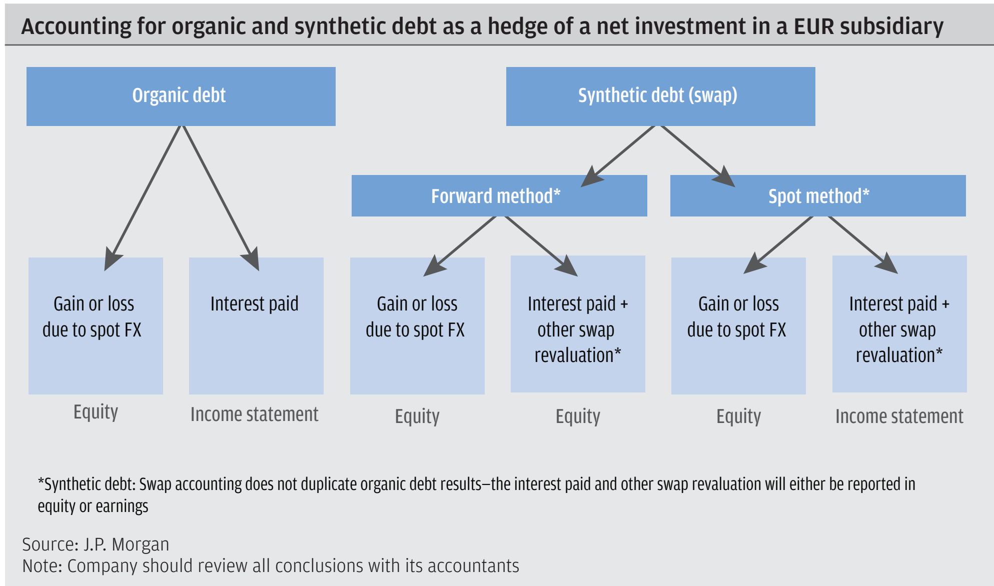
Accounting for organic and synthetic debt as a hedge of an intercompany loan



Source: J.P. Morgan
Note: Company should review all conclusions with its accountants

Figure 8

Accounting for organic and synthetic debt as a hedge of a net investment in a EUR subsidiary



Source: J.P. Morgan
Note: Company should review all conclusions with its accountants

6. Conclusion

- Decision makers have an opportunity to create shareholder value by accessing the EUR market if they have the right profile and wish to achieve the objectives outlined in this report of **lower economic risk, higher EPS and a more diversified investor base**
  - Moreover, companies that have USD funding needs may find a foreign currency issuance (EUR or another currency) swapped back to USD a **cheaper** way to borrow
- The economic objectives that can be achieved for companies with the right EUR profile can also be **achieved in other currencies** where foreign currency yields, credit spreads and basis are also favorable
- Companies executing large M&A transactions (whether cross-border or not) or addressing **shareholder activism demands for increased shareholder distributions through leverage** should also consider the benefits that could accrue from any additional debt in a foreign currency
- While real value can be created for shareholders by accessing foreign issuances—notably the EUR in today's environment—decision makers need to **be cognizant of and manage the financial and accounting risks** that can attend this economic and EPS value creation:
  - Leverage ratio risk if the foreign currency appreciates
  - Liquidity risk at maturity (if company decides not to roll over the foreign currency debt)
  - Accounting mismatches
- From our perspective, these **risks are worth the benefits** of creating real economic and EPS value when the right economic profile is present

Notes

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