SQUIRE PATTON BOGGS

Market Volatility and Hedging Risk

Corporations and Development Projects Be Aware

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The ongoing volatility in the global markets has several implications for corporations and development projects. One of the more pressing implications is risk management: treasury teams and deal teams should seriously consider their exposure to interest rates, foreign exchange rates and commodity prices, and accordingly, their ongoing hedging needs and hedging strategy.

As we continue to experience the effects of COVID-19, the Russia/Ukraine conflict, and inflationary pressures and supply chain disruptions across the globe, as well as a changing political landscape, we continue to see increasing interest rates, fluctuations in exchange rates and rising commodity prices.

What Could This Ongoing Volatility Mean?

As interest rates continue to rise, there is a possibility that mandatory interest rate hedging on new financing transactions will return and, even if not compulsory, there is an economic need for some element of interest rate hedging, both for existing and new financings. This, of course, will have an impact on cash flows, cash flow ratios, leverage ratios and forecasts, and covenant packages in financing arrangements.

Where an entity does business in multiple currencies or possibly has borrowed (or may borrow) in a single base currency when it uses other currencies in its business, the recent fluctuations in exchange rates (for example, GBP sterling) bring greater uncertainty with respect to the amount of money that will be available to it, as well as the cost of doing business generally.

Having experienced what is probably the largest commodity shock since the 1970s, and as supply chain issues continue, the costs of commodities continue to rise with no certainty as to when prices will moderate. Accordingly, corporations and development projects with a need for commodities (whether that be energy or building materials) may experience difficulties in obtaining, or managing the costs of, certain commodities, impacting their ability to carry out their business and/or complete projects. As business costs become more expensive, the overall success of an entity may be jeopardised. Continuing rising commodity prices may mean that any monetary or scheduling buffers built into development projects may not be sufficient to assure their timely or cost-effective completion.

Given this volatility, any existing derivative transactions that are subject to margining (whether mandatorily required by regulation or otherwise) could be subject to more frequent or extensive margin calls. A failure to satisfy margin calls would result in an event of default under the derivative documentation, and possibly trigger cross-default under other financing arrangements. Corporations and investment and project managers should engage experienced legal counsel to (a) understand what any margin arrangements require and (b) help ensure sufficient means of liquidity to satisfy any margin calls.

In the current market, entry into new derivative transactions is likely to be more expensive and the terms may be more aggressive. For example, even if margining is not mandatorily required by regulation, dealer counterparties may require margining or other credit support (such as a parent guarantee) that will factor into the cost of hedging transactions; however, the certainty that such transactions inure could far outweigh the cost of not hedging known risks.

What Should Corporations and Development Projects Be Thinking About?

Set out below is a list of items that it may be helpful to think about.

- What risks are your businesses exposed to?
- Do you need/want the flexibility to hedge such risks?
- Would you need to provide credit support to dealer counterparties?
- Do your existing financing arrangements with lenders, bondholders and other creditors permit you to enter into derivative transactions (and what types of derivative transactions)?
- Do your existing financing arrangements permit you to provide credit support for derivative transactions (and in what form)? If dealer counterparties are permitted to share in the security package for the wider financing arrangements, is such security on a parity basis, super senior basis or subordinated basis?
- On an ongoing basis, what creditor support would your various creditors be comfortable with you providing to dealer counterparties?
- Could any of the restrictions in existing financing arrangements, and proposed restrictions in new financing arrangements, limit your ability to hedge risks?
- Do you need to establish and/or update hedging relationships with dealer counterparties?

- What impact would the entry of new derivative transactions have on cash flows, cash flow ratios, leverage ratios and forecasts, and your ability to comply with covenant packages in financing arrangements?
- How should new derivative transactions be reported from a financial accounting aspect?
- Is the protection of building in a monetary buffer (rather than entering into hedging transactions) sufficient to protect the business in the long term?

More than ever, it is important to:

- Enlist experienced legal counsel to help you navigate your existing documentation and when entering into new financing arrangements, to negotiate terms to provide as much flexibility as possible to not hamper your hedging needs (which may be changing) and the ongoing success of your business
- Have ongoing dialogue with dealer counterparties to understand what terms may be available

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