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Tailored Proxy Hedge and Insurance Offer Promising New Pathways to Currency Risk Mitigation

Washington, DC, 2 May 2018: EMPEA today announced the findings of the report [Expanding Institutional Investment into Emerging Markets via Currency Risk Mitigation](#). The purpose of the report was to identify new solutions to currency risk, a key deterrent for investors considering long-term private equity opportunities in emerging markets. The chance that financial returns could diminish or even disappear when converted back into U.S. dollars or euros limits the available capital that could otherwise be invested in growing businesses around the world to create jobs and spur economic development. The report was a project funded by USAID where it partnered with lead organization Sarona Asset Management as well as Crystalus Inc. and EMPEA.

Several promising pathways were identified, including insurance and tailored proxy hedging, which aligned well with both general partner (GP) and limited partner (LP) criteria for viability. The tailored proxy hedge showed the most potential, and, consequently, it was piloted in a back-testing simulation using two actual EM fund manager portfolios. The partners and industry participants are optimistic about the results that demonstrated significant protection in certain economic stress events.

According to Gerhard Pries, CEO & Managing Partner of project lead Sarona Asset Management, “The fear of losing returns to currency fluctuations keeps billions of private equity dollars firmly on the sidelines – capital that could otherwise play a game-changing role in promoting sustainable growth across the world. The findings of this project help us advance towards market-ready solutions that can mobilize this capital for long-term, impactful investment.”

Currency Risk Mitigation Would Mobilize More Capital for Emerging Markets Investment

The development finance community has long recognized the need to mobilize greater private capital for long-term growth opportunities in emerging markets in order to raise economic standards globally. Achieving the Sustainable Development Goals depends on leveraging the substantial pools of private sector capital to augment public-sector spending. USAID has championed finding ways to mobilize this capital and remove barriers to investment. EMPEA was pleased to be able to support this most recent effort around solving for currency risk, which was also led by another of its member firms, Sarona Asset Management, and in partnership with Crystalus Inc. The foundational premise of the project aligned with the shared belief of EMPEA’s global membership community – private capital investment in emerging markets can deliver attractive financial returns while promoting the sustainable growth of companies and economies. The partners’ objective was to determine how to unlock more capital for investment and development by providing innovative solutions that could mitigate losses due to foreign exchange (FX) fluctuations.

EMPEA's 2016 [Currency Risk Management Survey](#), which was undertaken in partnership with AMEXCAP, found that 75% of global investors surveyed agreed that currency risk is an important or very important factor for their firm, while there was a lack of agreement on how to measure and mitigate this risk. According to EMPEA data, nearly 25% of the capital invested in emerging markets private equity (EM PE) deals between 2013 and 2015 was deployed into countries that experienced a depreciation of 30% or more in their currencies against the U.S. dollar. In EMPEA's 2017 [Global Limited Partners Survey](#), currency volatility topped the list of LPs' key macro and fundamental portfolio concerns and was the third most-cited reason for declines in new EM PE commitments.

EMPEA's Director of Research Jeff Schlapinski noted, "Institutional investors continue to cite currency risk as a key deterrent to further commitments to emerging markets, and FX fluctuations in recent years have likely played a role in less capital being raised to invest in some regions and countries. EMPEA has sought to address this issue with our members and in our research, with the goal of helping to identify solutions."

Investors Need an Innovative, Cost-Effective and Easy-to-Use FX Hedging Solution

A 2017 survey that was part of this project and conducted by EMPEA confirmed that a cost-effective FX hedging solution designed for long-term EM PE investments could mobilize sidelined capital. 70% of commercial institutional investors surveyed said that such an instrument would increase their appetite for investing in new and/or frontier markets where they had not yet invested. Small firms focused on a single market face the greatest need because they lack in-house resources to dedicate to FX management, and they do not benefit from diversification across multiple currencies or asset types. However, the survey also reaffirmed that there was sufficient demand for new solution ideas across firm size and geographic mandates. Approximately 87% of respondents (and 85% of GPs) believed it is important for GPs to hedge during the holding period of an investment, yet only 14% of GPs reported that their firm does so.

Most existing hedging approaches for PE are not viable due to cost, availability, suitability or undesired financial obligations that could be incurred. A working group of 12 fund managers and institutional investors identified the following preferences for a potential solution:

- A portfolio hedging approach is favored over single-currency solutions;
- Certainty of risk protection is generally preferred where possible, as historical correlations may not hold in the future;
- The cost/protection trade-off needs to strike the right balance;
- Upfront hedging costs are not ideal as they depress overall returns;
- Catastrophic FX coverage is more important than covering 100% of the FX risk; and,
- A low maintenance/low administration solution is more desirable.

An Innovative Insurance Product and Tailored Proxy Hedge Offer Promising Paths Forward

As part of this project, a global Request for Proposals (RFP) was issued to determine up to three proponents to work with in designing and developing new "proof of concept" FX risk mitigations tools specifically tailored to EM PE. The selected proposals included a direct hedging alternative (comprising coverures and supported range forwards), an insurance alternative and a tailored proxy portfolio

alternative. The project partners and working group evaluated the proposed solutions against the criteria identified from the industry responses.

Market testing with various focus groups comprising indicated that all four proof-of-concept solution ideas had merit – each with its benefits and challenges in terms of cost, protection, availability, and ease of use. In particular, the insurance concept had appealing attributes for investors, including simplicity and ease of use; however, because there currently is no reinsurance capacity for such a product, there was no immediate path forward to bring this to market. The tailored proxy hedge, developed by Validius Risk Management, gained substantial traction with the focus groups and consequently, was selected for “piloting” on the actual EM PE investment portfolios of two leading fund managers (one globally focused and one regionally focused).

The back-testing simulation pilot of the tailored proxy hedge on two real-world EM PE investment portfolios indicated overall promising results, including:

- The tailored proxy hedge provided substantial protection during two economic stress events (2008 global financial crisis and 2012-2015 commodity decline);
- Some protection was also seen in two other stress events (1998 crisis and 2013-2016 EM FX turbulence) for one of the portfolios tested; and,
- The tailored proxy hedge was cost-effective and the proxy portfolio actually made positive excess returns, which covered its implementation cost, for one of the portfolios.

While the tailored proxy hedge was found to be a potentially attractive and cost-effective portfolio-wide solution idea, key challenges remain including refining and simplifying its mechanics, cost and coverage, and where its use is most (and least) effective. This should be achieved via small-scale demonstrations in real-life, real-time EM PE investing scenarios.

Beyond identifying potential innovations for EM PE currency risk mitigation, this project helped to substantially move the yardsticks about how the industry thinks about, and acts on, this important issue. The initiative has already spurred new creative thinking and additional product ideas among FX risk mitigation specialists internationally, and key public and private stakeholders are encouraged to grow the dialog in testing and bringing new solutions to market.

Pat Brean, Managing Director of Crystalus Inc., commented on the findings, “We are excited to have identified some innovative approaches for emerging markets investors that succeeded in appealing to our focus groups, both GPs and LPs, and achieved promising results when market-tested on actual portfolios. However, there is still much more to do. More testing on real-life cases is needed as well as growing the understanding in the industry about what these new solutions can offer and how they work. I join the partners in this project in a call to action to global development practitioners to play a part in taking this effort forward.”

About the Project Partners

Sarona Asset Management – Lead Organization

Sarona invests in private companies in frontier and emerging markets, targeting strong financial returns, and positive ethical, social and environmental values. The firm, based in Canada and Netherlands, is a leader in innovative development finance, working with private and public partners to structure blended finance vehicles that achieve both financial goals and the Sustainable Development Goals. Sarona’s

mandates include direct and fund investment strategies focused on both debt and growth equity for private companies. www.saronafund.com

EMPEA

EMPEA is the global industry association for private capital in emerging markets. EMPEA is an independent non-profit organization with over 300 member firms, comprising institutional investors, fund managers and industry advisors, who together manage more than US\$1 trillion of assets and have offices in more than 100 countries across the globe. EMPEA supports its members through global authoritative intelligence, conferences, networking, education and advocacy with the broad purpose of catalyzing private investment in developing economies. www.empea.org

Crystalus Inc.

Crystalus Inc. is a leading international advisory firm specializing in development finance and risk management, including public-private partnering approaches, capital deployment, fund structuring, due diligence and best practices. Crystalus has advised on nearly US\$5 billion in new development finance initiatives, with clients spanning private-sector fund managers, multilateral development banks, development finance institutions, donor agencies, and major foundations. www.crystalus.ca