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Emerging Market Risk Protection Tools

Discussion Report

Treasury Management Association Conference

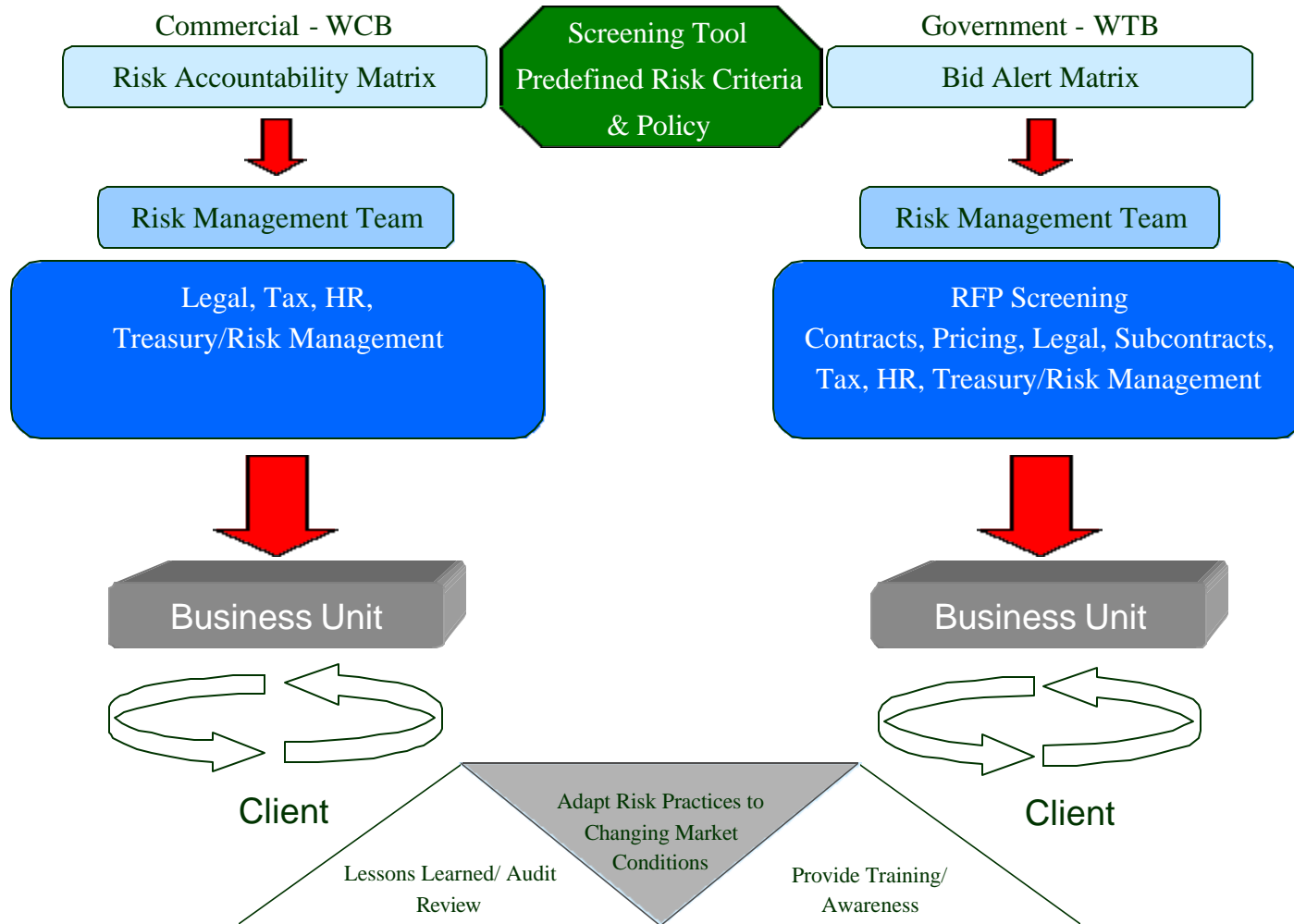
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PNC CAPITAL MARKETS

BOOZ·ALLEN & HAMILTON

Project Level Risk Management



BOOZ-ALLEN & HAMILTON GENERALLY ENCOUNTERS EMERGING MARKET RISK IN ONE OF THREE WAYS:



- Depending on which category the opportunity falls within, we assemble the appropriate internal/external resources to evaluate risks and support business unit.
- In general, we use a “swat” team approach to Risk Management as outlined on the previous page.

WHEN WE EVALUATE OPPORTUNITIES IN EMERGING MARKETS, WE GENERALLY REVIEW THE FOLLOWING ISSUES:

ISSUE	RISK CONTROL
Political Situation	Political Risk Insurance
Security/Safety/Health	Standard Guidelines Sensitization/Pre-Planning Contingency Plans
Tax/Legal <ul style="list-style-type: none"> • Permanent Establishment • Personal Taxes • Jurisdiction/Venue • VAT/Local Taxes 	Contractual Provisions Treaty Language Personal Filings
Credit Quality	Credit/Political Risk Insurance Standby L/C's Payment Schedule
Currency Risk/Bank Regulations	Central Bank Regulations Convertibility/Volatility Expense/Revenue Matching

Under all circumstances, we must “KNOW OUR CLIENT” !

WE WILL EXPLORE A COUPLE OF THESE RISKS IN GREATER DETAIL

Political Risk

- **The main types of commercial market political risk can be grouped under the generic headings of:**
 - Contract frustration -- (Export/Import risks) -- Non-payment, inconvertibility, contract repudiation, embargo/license cancellation, force majeure, war
 - On-demand, unfair calling of bonds
 - Confiscation
- **In general, Export Credit Agencies (ECA) provide insurance for many of these risks. However, there are many occasions when ECA's will not cover these risks:**
 - Goods or services which do not have enough "source" country component
 - Terms of payment which do not meet international standards subscribed to by ECA
 - ECA may not provide cover -- no capacity
- **In these circumstances, commercial market insurance may be available to fill the void.**

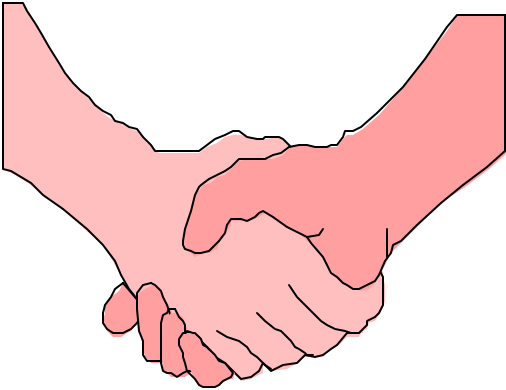
Credit Risk

- **There are a number of Export Assistance Programs available through agencies such as:**

Name	Service	WebSite
Export – Import Bank of the United States (Ex-IM Bank)	<ul style="list-style-type: none"> • Supports goods and services exported from the United States • Short-term policies, US content must be at least 50% • Medium and long-term policies, foreign content must be financed outside of Bank's programs 	www.exim.gov
Overseas Private Investment Corporation (OPIC)	<ul style="list-style-type: none"> • Insures investments overseas against a broad range of political risks • Finances businesses overseas through loans and loan guarantees • Finances private investment funds that provide equity to businesses overseas • Advocates the interests of the US business community overseas 	www.opic.gov
Finance, Credit and International Business (FCIB-NACM Corporation)	<ul style="list-style-type: none"> • Association of members specializing in exporting, financing, credit management, treasury and international subsidiary management • Sponsors US and European Round Table Conferences, Industry Export Credit Group Meetings, Workshops and Seminars • Provides country reports and company credit reports through outside agencies 	www.fcibnacm.com
Private credit insurance companies	<ul style="list-style-type: none"> • Political, credit risk protection products and service 	Numerous commercial insurers/brokers

Currency Risk

- In managing currency exposure, we look at a wide number of alternatives and adapt our approach based on negotiations with our client and the underlying business risks

Day 1	Day 15	Day 45
<p>OPPORTUNITY ARISES</p> <ul style="list-style-type: none">• Set proper frame of mind• Evaluate revenue/expense mix, balance sheet correlation/ natural hedges• Evaluate USD versus local currency• Establish pricing guidelines and pro-active pricing mechanism to reflect costs• Answer “Bid to Award” Risk issues• Include currency clauses, “make whole provisions”, “indexation”	<p>NEGOTIATE WITH CLIENT</p> 	<p>ASSIGNMENT/AWARD</p> <ul style="list-style-type: none">• Depending on success of negotiations:<ul style="list-style-type: none">– Do nothing– Hedge<ul style="list-style-type: none">• Use Forwards or NDFO’s• Use Options or NDFO’s• For On-Going Footprint issues:<ul style="list-style-type: none">– Local currency debt facilities established– USD accounts/procedures for conversion– Working capital management

IN MANAGING CURRENCY EXPOSURE, A NUMBER OF HEDGING TOOLS ARE AVAILABLE TO LIMIT OR REDUCE THE EXPOSURE

- **Forward Contracts**
- **Non-deliverable Forward Contracts**
- **Option Contracts**
- **Non-deliverable Option Contracts**
- **Local Currency Borrowing Arrangements**
- **Cross Currency Interest Rate Swaps**

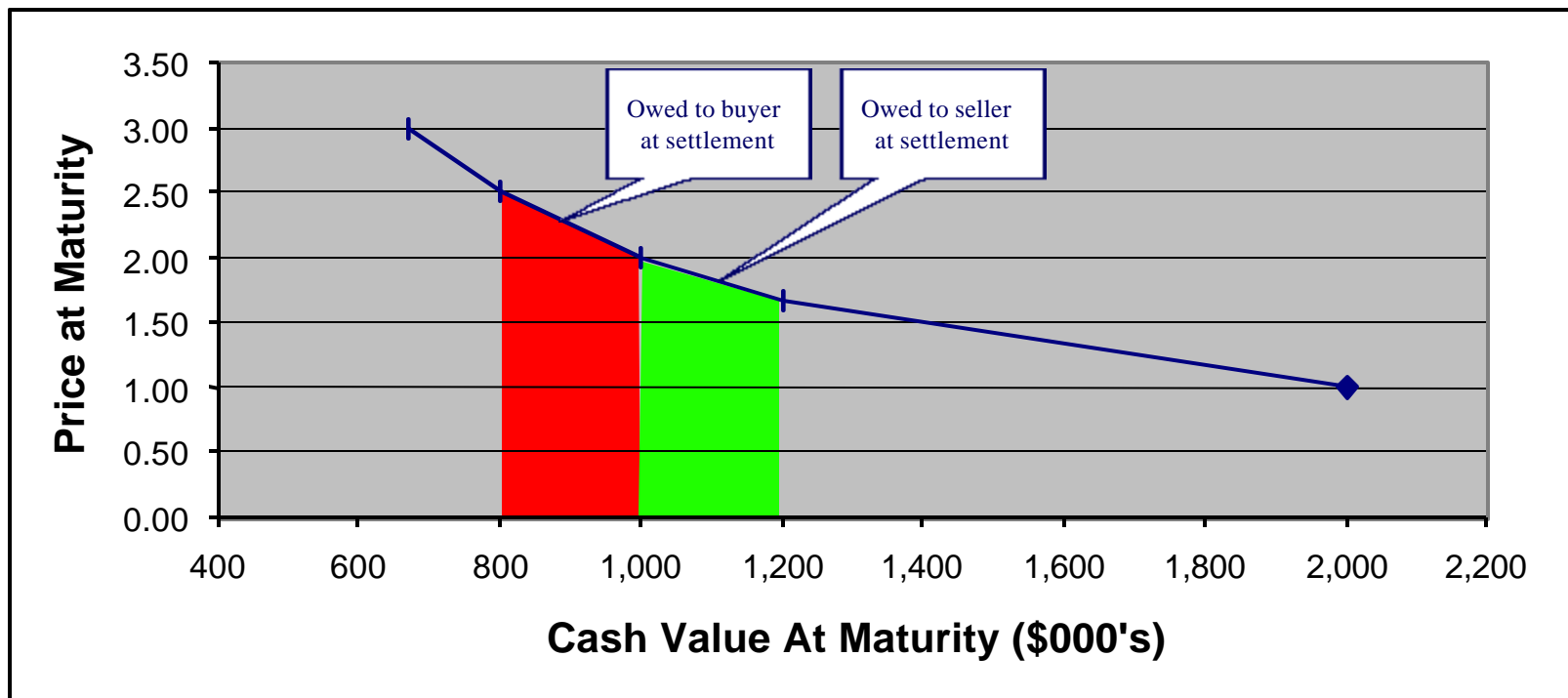
NON-DELIVERABLE FORWARDS AND OPTIONS DIFFER FROM TRADITIONAL FORWARDS AND OPTIONS IN THE FOLLOWING WAYS

Traditional Forwards	Non-Deliverables
Exchange of currencies permitted	On the settlement date, the exchange of currencies is not permitted
Gains or losses are not cash settled	On the settlement date, the forward or option is marked to market and the resulting cash gain or loss is received or paid

NON-DELIVERABLE FORWARDS AND OPTIONS DIFFER FROM TRADITIONAL FORWARDS AND OPTIONS IN THE FOLLOWING WAYS

■ For example:

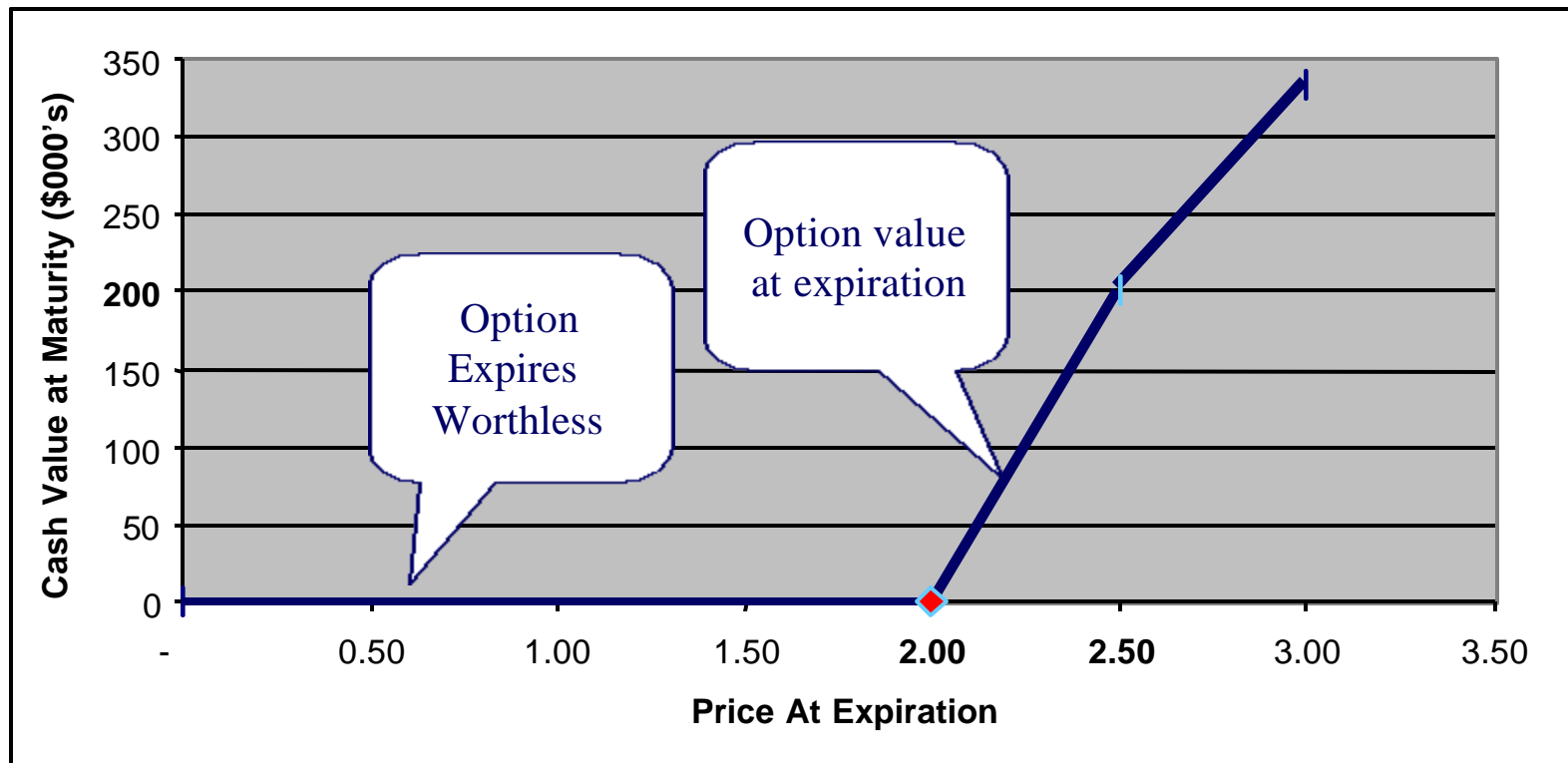
- A non-deliverable forward to sell 2,000,000 Brazilian reais at 2.0 reais per dollar (\$1,000,000 equivalent) would be marked to market at maturity as follows:



NON-DELIVERABLE FORWARDS AND OPTIONS DIFFER FROM TRADITIONAL FORWARDS AND OPTIONS IN THE FOLLOWING WAYS

■ For example:

- A non-deliverable option to sell 2,000,000 Brazilian reais at a strike price of 2.0 reais per dollar (\$1,000,000 equivalent) would be marked to market at maturity as follows:



ISSUES TO CONSIDER WHEN EVALUATING NDF'S

- **Is this the most cost effective tool?**
- **What is mark to market approach offered by the Bank and does it cover time zone issues, gaps in prices, suspension of trading?
Documentation is becoming standardized but it still needs review.**
- **What are tax consequences of the trade?**
- **Are you comfortable with the counterparty risk?**
- **What will you do to protect the cash held in country? How will it be moved/converted?**
- **What accounting treatment will you get for the trade?**

LOCAL CURRENCY BORROWINGS ARE A NATURAL HEDGING TOOL

- **Local currency cash flows (revenues) can be used to service the local currency debt (principal and interest).**
- **In general, expect a high level of interest rates in emerging markets.**
- **Government imposed debt/equity restrictions can sometimes impact utilization.**
- **Documentation takes time and patience.**
- **Yield curve management is critical as you want to avoid exchanging currency risk for interest rate risk.**

Conclusion

- **Know the reasons behind the business unit's entry into the "emerging market ."**
- **Know your customer.**
- **Get internal resources to work together.**
- **Establish and nurture a strong network of banks, advisors and other corporate contacts to help along the way.**