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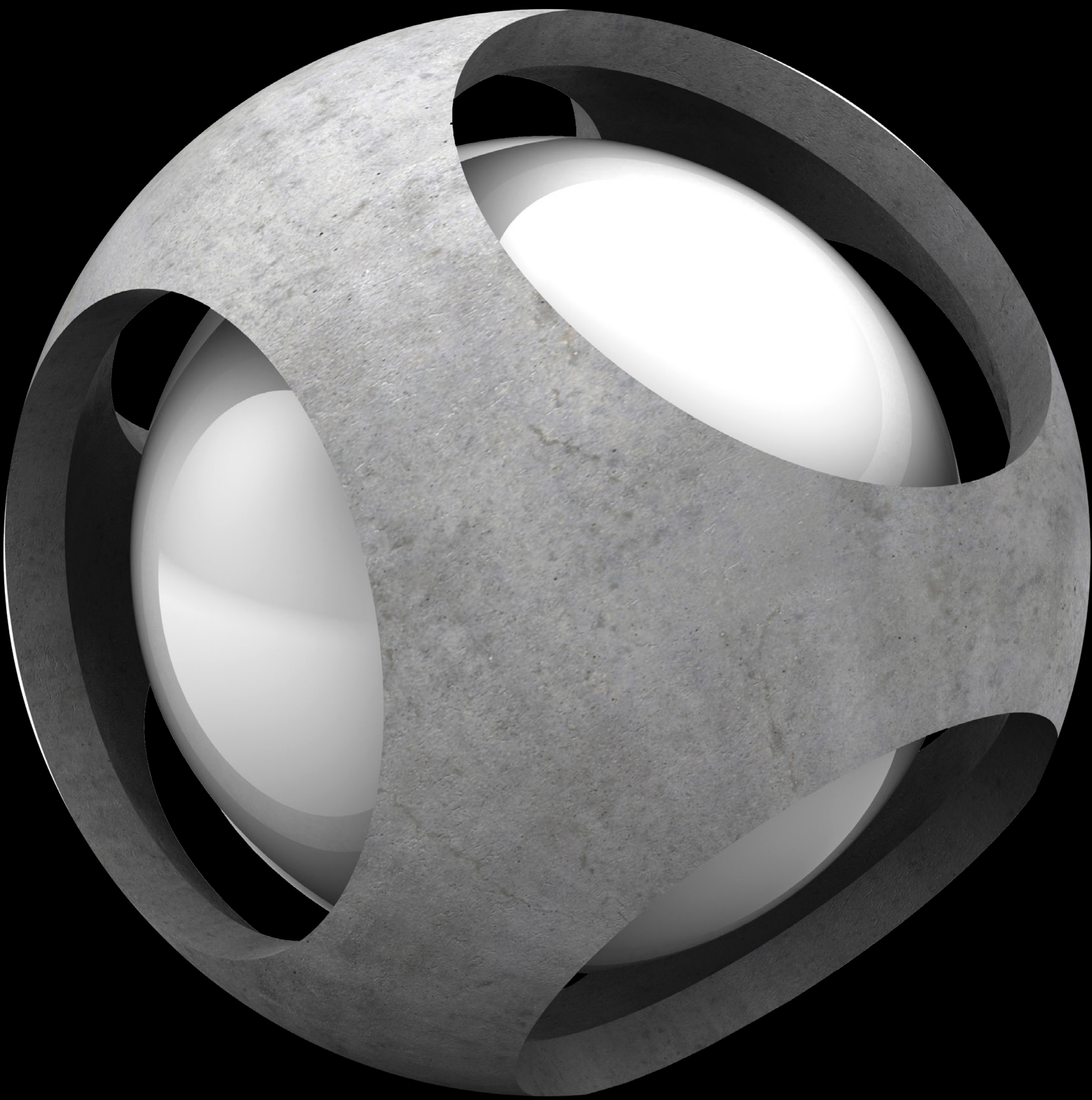

Debt and Capital Advisory

Derivatives strategy and execution

Increasing the flexibility and reducing the cost of financial risk management solutions

Case Study on interest rate hedging for a Listed REIT

Executive Summary

Our JSE listed Real Estate Investment Trust (REIT) client's business was focused on acquiring, developing, holding and selling real estate assets. During one particular acquisition, they had negotiated a financial package consisting of both debt and equity. The borrowings created a variable interest rate exposure, 60% of which the lender required to be hedged against interest rate increases as a condition of the lending package. Like so many other similar companies, the REIT did not fully possess the necessary staff, internal processes, at-the-trading desk experience, pricing tools and data to maximise its position relative to the derivative provider, and so they turned to Deloitte's Debt and Capital Advisory team for assistance. We helped them to set the terms of reference, negotiate the commercial terms of the ISDA documentation, monitor trade execution and validate the pricing afterwards. Our involvement led to cost savings that were multiples of the fees paid to Deloitte and improved contractual terms.

The Challenges

Both the REIT's financial risk management policy and the lender required the borrower to hedge a significant portion of the interest rate risk inherent in the variable rate bank loan. While our client's corporate treasury team had a good understanding of both interest rate derivatives and their markets, they only infrequently entered into derivative contracts, and consequently had not been willing to make the required investment in the systems, tools, data feeds and people required to comprehensively assess, structure and price these products. For this reason, they were aware that they would be at an informational, technological, staffing and data access disadvantage to their banking counterparties. Accordingly, they called upon Deloitte's derivatives strategy and execution team to help them eliminate this imbalance by supplementing their existing in-house capabilities with Deloitte's skills, expertise and capabilities - strategic and tactical advice, contractual documentation negotiation support, trade structuring, real-time execution monitoring, and pricing validation - to improve the commercial terms and drive down execution costs.

Our Propietary Process Explained

Deloitte guided the REIT through its unique end-to-end proprietary process outlined below:

GMAS Transaction Management Model (TMM)

There are three key phases to achieving world class derivative transaction management

Phase 1
Transaction Planning

1
- Clarify client objectives
- Identify optimal products and vendors
- Structure transaction

2
- Develop transaction strategy
- Engage with selected product vendors
- Determine transaction **Terms of Reference**

Phase 1 involves all the necessary analysis, data gathering and planning for a successful transaction, including selecting the accounting and legal professional advisors, contract documentation negotiation and establishing the pricing model for trading execution and post-trade validation purposes

1 week

Phase 2
Transaction Execution

Phase 2 consists of managing the client-vendor interface, fine-tuning the transaction structure and pricing to accommodate any intraday market changes and monitoring trading execution in real-time

3
- Procure final pricing from vendor(s)
- Establish preferred trade date and timing
- Client instruction to vendor to trade

4
- Adjust trade structure and pricing as required
- Monitor trade execution
- Finalise trade

1-2 days

Phase 3
Transaction Review

Phase 3 comprises all activities relating to the validation of the transaction execution pricing in **Phase 2**, conducting a a full review of all trade documentation and rectifying any inconsistencies

5
- Comparison of execution pricing to the **Terms of Reference**
- Full review of trade documentation
- Reconciliation of differences

6
- Engagement with vendor to rectify any inconsistencies
- Ongoing transaction monitoring as required

1-3 days

It is important for any company to possess the necessary systems, data feeds, people and capabilities to fully assess the efficiency of the structure, pricing and contract documentation for any derivative transaction, regardless of whether it is required by their own internal risk management policy or the lender, and then to ensure that the counter-party executes it as agreed.

Results and Benefit

Cost Savings

Deloitte helped the REIT to generate identifiable cost savings that were multiples of the fees paid. We achieved these savings by decomposing the swap price into the various elements that comprised it - the base rate, execution spread and regulatory costs - and then agreeing these as the Terms of Reference in advance of the trade date.

We calculated the base rate by bootstrapping and interpolating real-time market data across the trade's maturity profile. We determined the execution spread by referencing both historical and live trade date data for similar trades. And we estimated the appropriate regulatory costs using sophisticated quantitative techniques, which we then benchmarked by comparing these to our proprietary database of regulatory costs compiled from similar prior transactions with all the major derivative suppliers in the market.

By pre-agreeing the Terms of Reference in advance, we limited the counterparty's ability to vary these in their favour during execution of the trade, because they provided the necessary benchmarks for post-trade validation purposes.

Additional benefits

- Even though the lender's terms effectively constrained the REIT from running a competitive process, Deloitte's involvement ensured that the final pricing and terms were at least as good as if it had been able to do so.
- Deloitte assisted the REIT to tailor the ISDA Schedule template provided by the bank to its particular circumstances, thereby improving the commercial terms. Amongst other benefits, these amendments significantly curtailed the counterparty's discretion to declare an early termination event, and determine a price that was more favourable to itself in these circumstances.
- Deloitte's active involvement in the overall process freed up important internal resources for the REIT, enabling them to focus on other priorities that may otherwise have been delayed or compromised.
- From a corporate governance perspective, utilising an independent advisor in the specialised area of derivatives, where the REIT's own in-house skills, tools, systems and experience were less developed, provided the Risk Committee and Board with additional comfort.
- The REIT was able to preserve the quality of its banking relationships by pointing to its independent advisor as the reason for its improved position.
- The REIT could co-source the necessary expertise, experience, systems, tools and data feeds without having to invest in them.
- The REIT reduced its legal expenditure.

Total cost reduction is not only limited to what was achieved when the transaction was entered into, but also includes any potential gains attained by the company in an early termination scenario because of the ISDA Schedule amendments suggested by Deloitte