Zachary Scott
INVESTMENT BANKERS

INSIGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
SPRING 2003

Time to Protect Against Rising Interest Rates

Now is the time to develop an interest rate strategy.

by Michael T. Newsome

Interest rates don't invoke much impassioned debate these days. The prevailing view is that rates are low and stable and are likely to stay that way in the near term. So, what is there to do? After all, for many companies the most urgent issues are paring back debt and optimizing operations. Interest rate management is not much of a priority in the overall scheme of things. When you can borrow at an all-in rate of 3.5 to 4.5% (LIBOR plus 200-300 basis points), why worry? Debt has never been so cheap.

Nevertheless, complacency on this subject is not merited. Now is an opportune time for management to act on abnormally low interest rates to protect their businesses for the future.

HOW LOW IS LOW?

Under any reasonable scenario, we are at, or very near, the bottom of a historic interest rate trough. Rates are low, both on an absolute and a real basis. As shown in the nearby chart, long-term interest rates, as depicted by 10-year Treasury securities, have dropped to their lowest levels in 40 years.

While long-term rates are exceptionally low by any standard, short-term rates are even lower, barely eclipsing the 1% level. The current yield curve indicates a spread of approximately 2.99% between 1-month LIBOR and the 10-year Swap Rate. The Swap Rate is the fixed rate that is exchanged for the floating LIBOR rate in a swap transaction.

Over time, the differential between short- (3-month) and long-term (10-year) Treasury rates has averaged 1.40%. The current wide spread between short- and long-term rates provides a powerful incentive to float at the short end of the yield curve and enjoy the interest rate differential. And it begs the question, why move up the yield curve by 200 or more basis points to fix rates now?

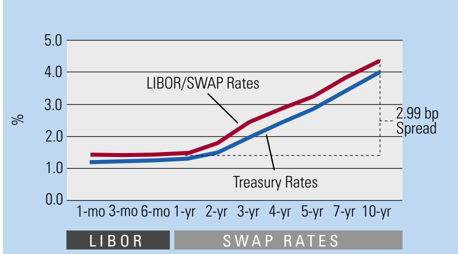
FORCES AFFECTING RATES

Interest rates over the long haul reflect investors' expectations for inflation and risk. In the short term, however, supply and demand have a significant effect on the level and configuration of rates. At present, a strong argument can be made that demand for high-quality debt securities has deflated rates abnormally, especially at the short end.

10 Year Treasury Yields

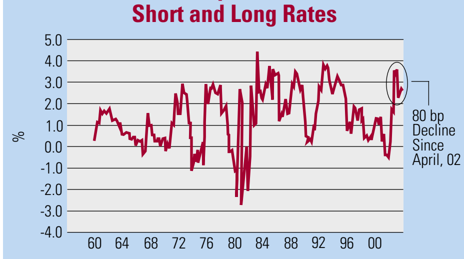
Source: Federal Reserve

Current Yield Curve



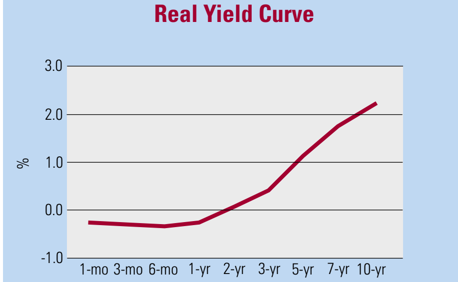
Source: Federal Reserve and WSJ As of April 29, 2003

Historical Spread Between Short and Long Rates



Source: Federal Reserve

Real Yield Curve



Source: Federal Reserve As of April 11, 2003 Adjusted for inflation of 1.5%

There are a variety of macroeconomic forces that have notably affected the current level of rates. First, the collapse of the growth-stock bubble reshaped investment patterns and spurred an exodus from mispriced equity markets toward less risky alternatives. As equity gains faded, investors shifted gears and made their way into safer havens like high-rated corporate bonds and government securities. The demand for high-quality debt instruments helped bring interest rates down sharply. A second factor that has contributed to low rates has been exceptionally weak credit demand, particularly among bank borrowers. As commercial credit demand slacked off, many banks replaced loans with bonds. This added demand for debt securities has further depressed interest rates, especially at the shorter end of the curve, as investors are simply in a holding pattern, waiting to see how things shake out.

Borrowers are now benefiting from circumstances in which the pricing in U.S. debt markets has come down to the point that real interest rates, after inflation, are negative. In essence, investors have accepted negative returns as the cost of a safe haven until they decide where to park their money long-term. The argument is that it is preferable to accept a small real loss in buying power in order to avoid much higher losses in other markets.

LOW RATES AREN'T FOREVER

Negative investment returns are not sustainable over time. The current rate environment seems to be a confluence, or "perfect storm," of global and domestic conditions. With high rates of unemployment locally, soldiers in Iraq, and an unpredictable North Korean regime, there is certainly reason for worry, but it always seems darkest right before dawn. As geo-political stability is restored and investors gain confidence in the domestic economy, there is no direction for rates to go but up, especially at the short end of the curve. It won't take much change of investor perspectives to affect the level and structure of interest rates.

(continued p.2)

WHO SHOULD CARE?

There are several types of businesses that should pay particular attention to the impact of higher interest rates. First, any business in which customer demand is adversely affected by rising interest rates is a good candidate to investigate hedging strategies. The need is most acute among firms that have debt as a major component of their long-term (greater than 3 or 4 years) capital structure.

We recommend consulting the specialists at your bank to develop specific technical hedging strategies. Nevertheless, we can offer a couple of suggestions.

Separate interest rate risk from credit structure. Interest rate swaps, caps, and options are generally better alternatives to fixed rate loans. Keeping borrowing arrangements on a floating rate basis provides greater flexibility to make adjustments to credit terms, as conditions warrant. It is unlikely that it will be necessary or advisable to adjust the mix of fixed- and floating-rate debt and the credit or capital structure at the same time, and you should avoid paying penalties to unwind interest rate commitments in order to adjust credit structure. While banks typically view the credit risk of a fixed-rate loan the same as a floating-rate loan, they view a derivative contract (swap, cap, option) as added credit exposure.

Lower interest rates have saved the bacon of more than a few leveraged businesses by lightening the interest burden. It would be tragic to have rising rates negate these benefits. There is an open window to take advantage of the current interest rate environment.

When negotiating your hedging strategy, you will want to retain the ability to keep the "hedge" in place if and when you decide to change lenders for the underlying borrowing. This may require a pledge of specific collateral, either at the time the hedge is implemented or at the time of a change.

An additional reason to favor a swap over a fixed-rate loan is that its value increases or decreases as interest rates move up or down. If it is necessary to unwind the swap at some future date and rates have moved up, the increase in the swap's value accrues to the company, rather than to the bank.

Hedge interest rates for a period that makes sense for your capital structure and business. The funding for long-life assets, such as plant and equipment, should be hedged for a corresponding term. The emphasis should be to protect against rate changes in the 3- through 10-year period, in order to take advantage of low short-term floating rates. Even if rates rise, it will take some time to erase the savings.

Monitor rates for signals of when to move from floating to fixed rates. Just like the equity markets, it is impossible to precisely time interest rates. But, you can maintain a sense of what interest rates are doing by looking at the actual level of, and the spread between, LIBOR and Swap Rates on a weekly or daily (if a decision is imminent) basis. Either your bank will provide regular quotes, or you can monitor rates in the Federal Reserve's daily posting of Statistical Release H.15 at www.federalreserve.gov/releases/h15/Update/.

Lower interest rates have saved the bacon of more than a few leveraged businesses by lightening the interest burden. It would be tragic to have rising rates negate these benefits. There is an open window to take advantage of the current interest rate environment. We can't know how long it will last, but you can be certain that if you don't have a defined hedging strategy, the opportunity will be lost. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com