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Taking Risk Out of Risky Times

Now is a good time to consider locking in longer-term fixed rates.

by Michael T. Newsome

Mitigating the sensitivity of business cash flows to the movement of interest rates is the prime motivation of hedging and is usually achieved with interest rate derivatives (swap, cap or collar contracts). An alternative, and perhaps more common, rationale for employing interest rate derivatives is an effort to time the market to reduce the cost of capital. No matter whether the objective is hedging or market-timing, now is a prudent time to consider locking in longer-term fixed rates.

The adjacent hedging matrix offers guidance for hedging strategy based upon the shape of the yield curve, Fed policy, and economic activity. For example, a steep yield curve, loosening Fed policy, and an economy gathering steam signals that interest rates are expected to rise. Therefore, locking in up to 75% of debt with longer-term fixed rates likely would be beneficial. Conversely, a flat or inverted yield curve, coupled with tight Fed policy and a slowing economy, implies falling rates and a strategy of staying predominately short with floating rates.

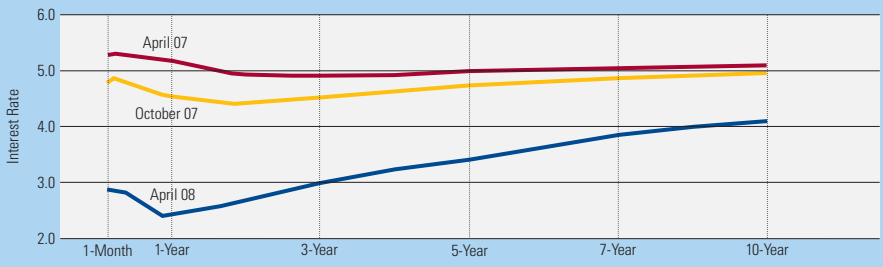
With the economy sagging, the normal inclination would be to stay short in the hope of further rate softening. But, for the reasons outlined in the preceding article, low or falling rates may not be a safe bet. We are not strong proponents of market-timing, as the effort seldom hit the mark. Nevertheless, long-term rates approaching the 40-year lows achieved in 2003 and the prospects for escalating inflation are two compelling reasons to consider hedging alternatives now.

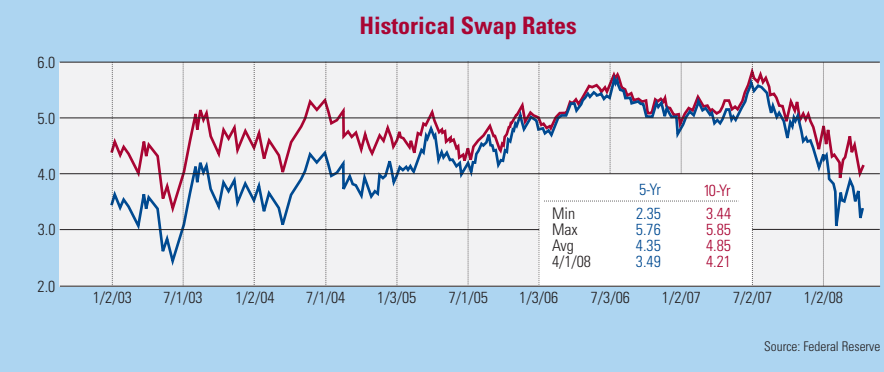
Current credit market volatility has created an unusually inverted yield curve through the first 24 months, in anticipation of further short-term rate reductions. Beyond two years, a steeper, more normal curve reflects an expectation that rates will rebound. If concerns about future inflation are valid, long-term rates will continue to rise, dragging the entire yield curve upwards.

To strike the fine balance between flexibility and the lowest all-in cost of capital, the guidance of a hedging advisor can be valuable in the development and implementation of a hedging strategy. Of course, banks are an excellent source of expertise, as interest rate risk is central to their business. But, in a complex market that lacks pricing transparency, an independent advisor offers some meaningful advantages:

Interest Rate Direction	LIKELY HIGHER →		Neutral	← LIKELY LOWER		
Yield Curve	Steepest	Steepest	Flattening	Flat	Flat	Inverted
Federal Reserve Activity	Loosening	Steady	Steady	Modest Tightening	Tightening	Tightest
Economic Activity	Slow Recovery	Growth	Growth	Slowing	Slowing	Recession
% Hedged	Max Fixed 75%	Medium Fixed 60%	50%	40%	Minimum Fixed 35%	30%
Maturities	Maximum 10-30 Yrs	Medium 5-10 Yrs	5-7 Yrs	1-5 Yrs	Minimum 1-3 Yrs	0-2 Yrs
Hedging Instruments	Swaps, Forward Swaps, Collars			Reverse Swaps, Reverse Forward Swaps, Caps		

■ ***A broader range of alternatives.*** Swap providers have a natural predisposition toward hedging approaches that offer the greatest profit. To that end, bankers often push long-dated swap contracts, with lucrative embedded





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fees, rather than rate caps or collars that also provide the desired protection and flexibility for a flat premium.

- ***Real-time information.*** Breaking economic news can materially move derivative-market pricing in a matter of minutes. Most middle-market companies do not have access to the real-time market information necessary to monitor the market closely for opportunities or compare quotes from multiple sources.
- ***Pricing transparency.*** The compensation for the provider built into a swap quote can vary widely in the absence of pricing insight. An independent advisor can quantify the spread and inject competition into the process.

We can offer a few suggestions regarding hedging strategies:

Separate hedging from credit structure. Structuring hedges (swaps, caps, collars) that are independent from debt is generally superior to a fixed-rate loan that is often subject to a prepayment penalty. Keeping borrowing arrangements on a floating rate basis provides greater flexibility to make adjustments to credit terms as conditions warrant, without unwinding interest rate commitments and tripping make-whole provisions.

Banks view the credit risk of a fixed-rate loan the same as for a floating rate loan, while swap or collar contracts are perceived as added credit exposure. When arranging derivative contracts, it is worthwhile to have an ability to preserve the hedge, in the event it is necessary 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 change.

Finally, the value of a derivative contract increases or decreases as interest rates move up or down. The gain or loss accrues to the borrower. In the case of a terminated fixed-rate loan, it is not unusual for the borrower to pay a prepayment penalty, without regard to the movement of interest rates.

Hedge interest rates for a period that makes sense based on capital structure and business. The funding for long-life assets, such as plant and equipment, should be hedged for a corresponding duration[1] .

Any business in which customer demand is adversely impacted by rising interest rates should pay particular attention to interest rate risk. The concern is most acute in firms where debt is a major component of their long-term (> 3-4 years) capital structure. Rising rates are reflected in both increased borrowing costs and reduced operating earnings. This combination can painfully erode the capacity to service debt.

Lower interest rates have saved the bacon of many leveraged businesses by lightening the interest burden. It would be tragic to permit rising rates to undercut the economics envisioned at the time of the borrowing. There is an open window to take advantage of the current interest rate environment. We can't know how long it will last, but it is certain that without a defined interest rate strategy, today's opportunity will be lost. ❖

[1] *Weighted average maturity of an asset's or a liability's cash flow.*

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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.

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