Zachary Scott
INVESTMENT BANKERS

IN$IGHT REPRINT
PERSPECTIVES ON THE CAPITAL MARKETS
SPRING 2010

Predicting Future Interest Rates

Rates will be going up and vulnerable business owners should get prepared.

by Michael T. Newsome

Interest rates are nearly as low as they can be, as illustrated in the chart on the following page. The Federal Reserve has signaled that it will attempt to quickly withdraw liquidity from the credit market at the first sign of inflation. The question does not seem to be whether or not rates will rise, but rather when and by how much.

Users of senior debt have enjoyed nirvana since 2000. With the support of the Fed's efforts to drive down rates, businesses have funded the expansion of long-term assets with variable-rate debt, in the predominately floating-rate bank market. Staying at the short end of the curve has been a winning strategy and made interest rate risk management a less important endeavor. As a consequence, the focus has been on credit spread, rather than the long-term, all-in cost.

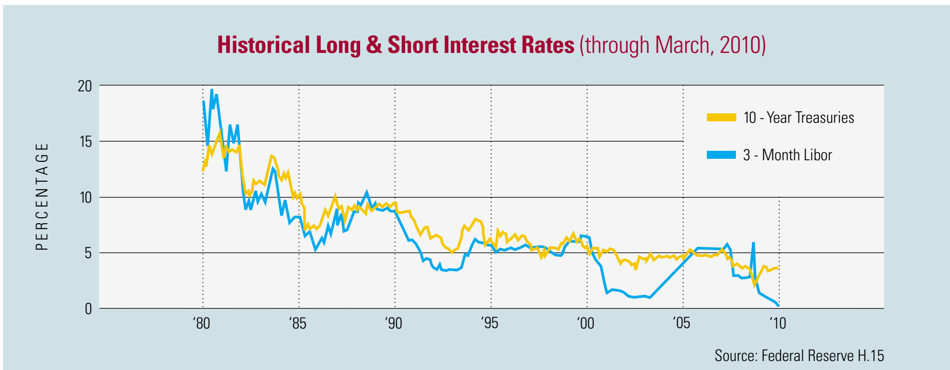
However, the interest rate risk currently being borne by businesses is potentially catastrophic. Whereas companies have been hit hard on the revenue line since 2007, interest-rate movements could increase credit expense several fold. The double-whammy of eroding EBITDA and higher debt service obligations could create a difficult set of hurdles for borrowers with above-average leverage. It is incumbent upon business managers to take seriously the job of insuring against that outcome.

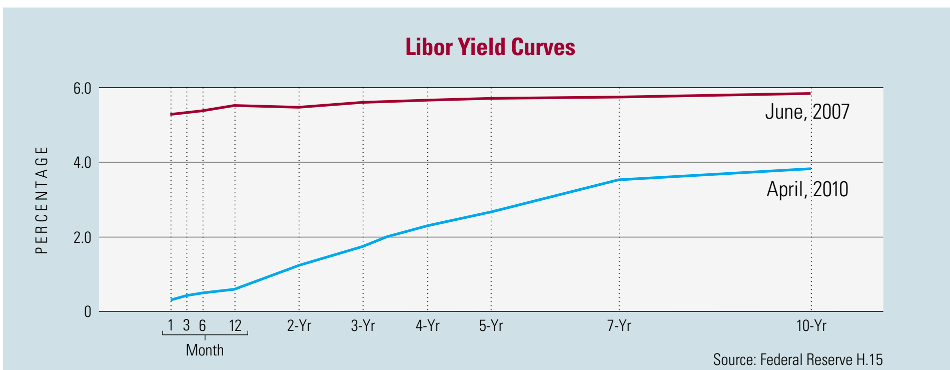
As illustrated in the nearby yield curve chart, one-month Libor has declined 500 basis points since the eve of the financial crisis in June of 2007. At 32 basis points, as of April 15th, there is little room to move lower.

In addition, the shape of the yield curve has changed markedly in the last 30 months as short-term rates have fallen relative to long-term rates. The gap between one-month Libor and the 10-year swap rate now exceeds 380 basis points. This is compared to a 44 basis point differential in 2007.

FUTURE INTEREST RATES

The "$64,000" question is, how long will rates remain at these levels? We are certainly not in the business of predicting interest rates, regardless of this article's title, but the current slope of the yield curve is generally indicative of an expectation of rising rates as we look out beyond 2010. If business owners have learned anything over the past three years, it should be that change can occur rapidly, often unpredictably.





INTEREST RATE RISK MANAGEMENT

Knowing that it makes sense to hedge against rising interest rates is one thing. Implementing the optimal strategy is another. In our view, interest rate risk mitigation should be approached from the insurance perspective – protection against a potentially catastrophic risk to the quality and stability of the cash flow stream and the corresponding value of the business. Obviously, insurance has a cost. So, how much interest rate protection is needed, and for how long, has cost implications.

Managing interest rate risk revolves around the concept of "duration," which may be broadly (and inartfully) defined as the weighted-average time to reprice the assets and liabilities of a business. As an example, a slump in the value of the dollar might result in higher interest rates, but might also boost businesses engaged in the export market. An importer, on the other hand, might think about that quite differently. Businesses that have their assets constantly repriced are not as concerned about the impact of inflation or deflation on their business, whereas companies that have long-duration assets and/or long-dated cost or revenue elements (e.g., manufacturing plants, long-dated real estate leases, long-term pricing contracts) could experience a much greater impact. The point of this is that an appropriate interest rate strategy for one business might not be well suited to another.

No company with variable rate debt can afford to ignore its exposure to interest rate fluctuations. An effective interest rate strategy enables a business to better manage its exposure to unpredictable interest rate conditions on the underlying business.

Banks are a prime source of expertise, as interest rate risk is central to their business,

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but there are advantages to consulting an independent expert who can help you fairly evaluate the amount and duration of insurance that is needed, the timing of implementation, and the cost tradeoffs of utilizing different tools:

■ The best alternative. Swap providers are in the business to make money. To that end, bankers often push long-dated swap or collar contracts, with lucrative embedded fees, rather than rate caps or other option-based hedging strategies that provide adequate protection at a lower cost. Banks generally expect the same spread on a swap or collar, which embody some credit risk based on the client's obligation to make payments if rates fall. With an option-based hedge, there is no credit exposure, which means the client can consider providers other than its credit bank[s].

■ Real-time information. Breaking economic news can significantly move derivative-market pricing in a matter of minutes. Since there can be material intra-day movements, comparing multiple proposals over a several day period can be meaningless. An advisor with access to real-time market data is best able to find the most favorable alternative.

■ Pricing transparency. A swap quote includes imbedded profits for the provider. An independent advisor can quantify the economics of various providers, so alternatives are fairly compared.

The starting point is quantification of interest rate exposure and the potential impact if left unhedged. Because rates are dynamic, regular review and adjustment is necessary. Now, we would argue, is the time to initiate a careful interest rate risk review with the objective of developing and executing a management strategy customized to your business. Waiting is simply a decision to bear the risk. ❖

Zachary Scott
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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