Wealth Design
Financial Engineering

Business Financial Risk Protection

Companies routinely take out property and casualty insurance policies to protect themselves against the risk of damage caused by fire, theft, storm, or other potential happenstances. But few stop to consider whether various macro-economic business risks (which may have a far greater impact on shareholder value) can be transferred to a third party in the same way.

Higher interest rates or commodity prices are an example of business risks that can seriously damage a company's bottom-line profitability and asset value. Yet most companies still regard these risks as the inevitable, uninsurable perils of entrepreneurialism.

Companies are starting to recognize the value in implementing *business financial risk protection transactions* to preserve or even increase shareholder value in terms of return on equity (ROE) by protecting the business cash flow, reducing the amount of capital tied up in the business, or improving their financing terms. In essence, they see business financial risk protection as a new and efficient source of capital.

For the past several years, most short-term interest rate indices have been hovering around their historic lows. This confronts many borrowers with floating-rate financing agreements having an exceptionally low variable component of their financing costs.

Following the unprecedented disruption in the financial markets and the arrival of a much-talked-about economic recession, the Federal Reserve took repeated aggressive actions, which have a very high probability of resulting in interest rates increasing dramatically over the mid-term. After all, common wisdom tells us that sooner or later, inflation will eventually catch up, and interest rates will move higher. This inevitability makes the decision to protect against the adverse economic effects of higher rates critical for the ongoing welfare of the company, and also quite urgent.

However, the hedging decision is not a straightforward one and should involve the analysis of several factors:

Business Plans / Cash Flow Forecasts

Nowadays, companies need to take a hard look at the availability of future debt financing and at their ability to reliably estimate future debt balances. In today's business climate marked by reduced earnings estimates, downsizing across many sectors, and a reduction in many development projects, hedging becomes a very important part of cash flow planning. A sudden unexpected increase in financing costs can be very detrimental to short- and long-term forecasts.

However, the wrong approach to hedging can be particularly painful. Years ago, many companies did hedging with pay-

fixed interest rate Swaps, which have since become a liability because rates decreased even further. They made a bet years ago that interest rates would escalate, and locked in a higher fixed rate at the time. Because rates have decreased since that time, these companies have been paying interest costs substantially higher than if they had kept their variable rate. Now, if they want to terminate the Swap, they would incur huge breakage costs. It is not that the Swap itself was bad, but that they made the wrong bet.

Financial Sensitivity to Interest Rates

How sensitive is the company to LIBOR rates above a certain level? What is the impact on net income and cash flow if variable rates increase to 6%, for example? These are questions that should be answered in order to determine the optimal amount to hedge and how that number fits into the company's operating strategy.

The technical term for the financial sensitivity of a company to interest rates is called "elasticity." There are many elasticities that can be measured to predict the effect on a going concern of operating in a higher interest rate economy. A proper Risk Analysis can quantify the financial effects of macro-economic risks on a company.

Many companies look to protect the value of the business itself, or of the purchasing power of the business income, as opposed to hedging a specific variable rate loan. This type of business "insurance" provides the owner with protection against insolvency if the economy goes through a protracted period of hyper-inflation.

Credit Availability and Banking Relationships

This point is increasingly important, as banks have become very selective about which counterparties they are willing to face in derivative and hedging transactions. This is particularly the case for credit-intensive hedging strategies such as interest rate Swaps. Depending on the creditworthiness of the company, management and finance teams typically have to navigate a very difficult negotiation process with dealer banks over terms involving collateral, guarantees, and the maximum hedge notional that the bank is willing to offer.

For example, a real estate firm recently attempted to enter into an interest rate Swap to achieve certainty of debt service coverage but was unable to find any counterparties willing to offer a Swap at reasonable terms. Consequently, rather than subjecting itself to a very high credit charge on the Swap or the typically onerous requirements to post collateral, the firm decided to purchase an interest rate Cap instead.

Type of Hedge Product

Navigating the hedging strategy decision is critical and depends not just on company- or business-specific factors, but also on conditions in the market at the time when the strategy is implemented. This is not an easy decision, but in today's environment characterized by extreme market volatility and low absolute levels

in rates, certain advantages and drawbacks of traditional hedging strategies have become more apparent. For example, Caps could be prohibitive due to their high upfront cost; however, as shown in the above situation, they can be advantageous because they do not require credit approval from the hedge provider. On the other hand, Swaps have no upfront cost but require credit, and despite having the advantage of providing a known, locked-in rate for the duration of the hedge, many companies are reluctant to take the risk of locking in higher fixed financing costs now when variable rates are so low.

These drawbacks lead many companies to seek hybrid hedging designs, which are becoming more attractive due to their flexibilities and more advantageous accounting and tax treatment. The benefits of these designs allow companies to minimize their cash outlay without locking in higher rates now.

Accounting and Tax Treatment

To achieve optimum hedge accounting and tax treatment has become a critical component of the hedging decision. In these difficult times where every dollar of cash flow counts, how a hedge is accounted for and taxed can have a significant impact on cash flow. Unfortunately, there is very little analysis of the tax aspects of these sophisticated transactions. This is largely due to the fact that most CPAs and tax attorneys do not have any experience in the field of derivative taxation. However, through an understanding of the tax attributes of the underlying instruments, cash flow efficiencies can be achieved that can greatly reduce the cost of the hedge.

A key question is whether a transaction meets the "tax definition" of a hedge. This is because gains and losses on derivative transactions that meet the tax hedge definition are eligible for ordinary income and loss treatment. If the transaction does not meet the tax hedge definition, gains and losses are treated as capital.

The arrangement of a transaction to meet the tax definition of a hedge is something companies strive to achieve in most cases, because ordinary treatment is generally more preferable than capital. Not only must the transaction meet the specific definition, but also the taxpayer must properly identify it at inception to qualify for the favorable ordinary tax treatment

Conclusion

Based upon an analysis of the business and the identification and quantification of various macro-economic risks that may adversely affect values, companies should seriously consider implementing a hedging strategy. There are many new hedging strategies that are cost-effective ways of protecting the value of a company, while having a positive impact on the bottom line.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.