Interest Rate Risk of Successful Business Owners

Introduction

Successful small business owners are generally high net worth individuals. They own a valuable business, enjoy the lifestyle benefits of high income from their company, and own substantial investments outside their business. It is these successful business owners whose entire net worth is subject to risk, and thus whose lifestyle is most apt to suffer in the event of a systemic or macro-economic crisis.

Almost all business owners are exposed to interest rate risk, however this risk can manifest itself in different ways. A proper response to this risk can only come following a full understanding of the context of the firm and its strategy, along with a full evaluation of the risk. The vast majority of literature on interest rate risk is limited to Asset/Liability Matching (ALM) of financial firms like banks to manage the risk of their lending portfolios. Unfortunately, this is only one aspect of interest rate risk. We are not looking solely at transaction-oriented micro-economic risk management, but the broader macro-economic picture.

Primary Manifestations of Interest Rate Risk on Businesses

Interest rate risk is the exposure of a business to changing interest rates. The adverse impact of operating a business in a higher interest rate economic environment has four main dimensions:

1. Higher Cost of Interest Expense

Companies with debt charged at variable rates (floating rate loans) will be exposed to higher interest expense as interest rates rise. Higher expenses result in reduced business profitability.

2. Impact on Business Performance by a Changing Economic Environment

Higher interest rates also affect businesses indirectly, through their effect on the overall business environment. For example, construction firms enjoy a rise in business activity when interest rates are low, as investors build more when the cost of projects is lower. Very few business models become more profitable in a higher interest economy. The vast majority will suffer a loss of profitability during inflationary times as credit is restricted and consumption is reduced.

If interest rates rise to 4% or 5% or even 6%, it will pretty much be business as usual. However, for most firms, it is when rates rise above 7% where business models start to break down and the negative effects of conducting business in a higher interest rate economy begin to be overtly felt. The business owner will be making less money and his lifestyle will cost much more, forcing him to sacrifice his lifestyle.

3. Impact on Market Value of Assets

Higher interest rates will immediately reduce the value of most assets. The definition of Interest Rates:

> *A measure of the ratio of a promised future dollar of cash flow to the current market value of that cash flow.*

Thus, higher interest rates diminish the current market value of the asset that generates such cash flow. This lower ratio affects the valuation of future cash flow from assets such as stocks, bonds, real estate and businesses.

You have heard that bond values decline in proportion to rising interest rates. This is because when you discount the future cash flow of the bond at a higher interest rate, its present value immediately decreases. For example:

A bond has a coupon that pays $1,000/year for 10 years

@ 3% current interest rate:	Bond value = $8,530
@ 8% current interest rate:	Bond value = $6,710 (21% loss)
@12% current interest rate:	Bond value = $5,650 (34% loss)

This same relationship exists with all assets. Businesses, real estate, stocks, etc, are all valued at the Present Value of their future profitability. The higher the interest rate that you use to discount the PV, the lower the current value. Thus when interest rates rise, business values, real estate, stocks and bonds all decline in value.

As interest rates rise, the devaluations due to the higher discounting of current market value will occur, but will be largely imperceptible to the business owner. Business values are not "marked to market," so there is never a clear picture of how the business value has declined. Unless the owner is trying to sell his business at this time will the loss of value be noticed. The market value of the business at an 8% discount to future earnings will be much less than if it is discounted at 4%.

4. Impact on Purchasing Power

Inflation is by definition the average rate of increase of prices for goods and services. Thus, inflation reduces the purchasing power of any given future cash flow. The value of a dollar of income declines as rates rise. If the rate of inflation is higher than the return you are getting on your investments, your net rate of return will be negative.

The reduction of purchasing power is a double-whammy because, as we have outlined above, the business owner will be making less profits in a higher interest rate economy, and his smaller income will be buying less goods and services.

Conclusion

The bottom line is that whenever interest rates rise above nominal levels, the successful business owner will suffer many more negative consequences than he will experience positive consequences of higher rates.

While there is no "*Catastrophic Economy Insurance*," there are ways to protect your net worth if a very bad economy materializes. Certainly one hallmark of a bad economy is higher interest rates, thus a good way to protect against the effects of a bad economy is to hedge the risk of high interest rates. If the business owner purchased a Risk Control Instrument (RCI) that protects against rising interest rates, the RCI would make cash payments each year that rates are high. These RCI cash payments could be designed to precisely offset the loss of value that could be experienced as rates rise.

Such a RCI could be considered "Net Worth Protection" or "Financial Crisis Insurance." The additional cash created could keep the business solvent and the lifestyle of the business owner intact.