



What Do Rising Interest Rates Mean for Treasurers?

Stephen Baird - [Treasury Strategies Inc.](#) - 22 November 2004

Corporate treasurers noted higher interest rates this past summer when the Fed raised the federal funds rate 75 basis points. Though long anticipated, the central bank's actions represent a milestone, having raised the benchmark overnight lending rate from a 46-year low of one percent. Although continued mixed economic data should encourage the Fed to proceed cautiously, most economists expect a more tightening of monetary policy through 2005.

Few treasurers are surprised by these developments, assuming both ends of the yield curve must eventually revert toward long-term average levels. They understand the myriad of forces that drive yields higher including rising commodity prices, U.S. budget deficits and a tightening money supply. Most ominous is the prospect of a monetary policy change among the Asian central banks, should those economies grow wary of subsidizing the U.S. dollar and bond markets through continued treasury purchases.

Corporate borrowers have taken every possible measure to lock in long-term rates over the past few years. U.S. corporate bond issues reached record levels in 2002 and 2003, totaling nearly \$5 trillion last year, as companies refunded older, higher-cost issues to take advantage of historically low rates. During the same period, corporate hedging usage surged, with outstanding national amounts of over-the-counter interest rate hedges nearly doubling between 2001 and 2003 to \$142 trillion.

Treasurers have gathered their acorns for the coming winter. Having toiled to bring deals to market despite tight credit conditions, it would appear they can now enjoy bragging rights to sweetheart coupon and swap rates for years to come.

More Work to Be Done

Nevertheless, a higher interest rate regime would present serious threats, even to a hedged balance sheet. The first threat is that the hedge is incomplete.

The current debt portfolio reflects a trade-off of competing objectives including the desire to protect against rising rates, and the need to maintain sources of liquidity and enhance ROI through a balance of maturities. Rising rates are already increasing backup liquidity fees, short-term borrowing costs and anticipated refinancing rates. Should rates rise dramatically - as they did in 1994 when the Fed raised fed funds 300 basis points in a 12-month period and sent shock waves across the financial markets - the impact on corporate debt service and liquidity could be dramatic.

Now is the time to ask questions about the company's risk management policy:

- Have all of the interest-rate exposures been identified and quantified?
- Has the company established a comprehensive risk management framework of policies and procedures that are linked to maximizing shareholder value?
- When does accepting interest-rate risk enhance shareholder value and when should it be controlled?
- What is the company's fixed/floating mix objective? What metrics are used to evaluate exposure? On what basis was the target established?

Treasurers who are uneasy with the answers to these questions should approach these issues with urgency, as Monday-morning quarterbacks are sure to emerge from the ranks of CFO's, CEO's and boards of directors in the coming years.

Implications for Shareholder Value

The second threat raised by higher interest rates presents less issues of accountability for the corporate treasurer but more serious concerns for the financial success of the firm. A new era of higher capital costs could bring the long-term dissipation of corporate value and growth.

Higher borrowing rates result in a higher cost of capital. Here is a review of the equations identifying the components of the weighted average cost of capital (WACC):

$$\text{WACC} = \text{After-Tax Cost of Debt} \times \text{Debt/Capital} + \text{Cost of Equity} \times \text{Equity/Capital}$$

If we employ the CAPM model to derive cost of equity:

$$\text{Cost of Equity} = \text{Risk-Free Rate} + \text{Market Premium} \times \text{Beta}$$

Higher interest rates increase not only the cost of the debt component of the cost of capital, but also the cost of equity via the risk-free rate (a long-term U.S. treasury bond yield).

Looking at an equation relating shareholder value to the cost of capital:

$$\text{EVA} = \text{After-Tax Operating Income} - \text{Capital Charge, where}$$

$$\text{Capital Charge} = \text{Capital} \times \text{Cost of Capital}$$

Since the enterprise value of the firm is the discounted present value of the company's EVA stream plus the capital base, a high cost of capital translates to depressed stock prices. Any additional investment by the company that does not generate a positive spread above this higher cost of capital generates a negative stream of EVA and destroys shareholder value. Higher hurdle rates mean less value-creating investment opportunities.

As interest rates rise, bonds become a more attractive investment option, particularly for investors who plan to hold the bonds until maturity. The increased competition for investment dollars can pressure stock prices. Earnings drag is created by higher interest expense. These effects are determined by the level of market rates, irrespective of the advantageous long-term rate a prescient treasurer may have locked in through well-timed issuance and hedging.

Treasurer's Action Plan

It is impossible to know when high interest rates will occur. Here are four initiatives treasury departments should begin while yields remain at historically low levels.

1. Reengineer the Risk Management Program

Any hedging decision creates a dilemma. If the hedged risk does not materialize, then did you hedge too much? In the case of interest rate hedging, did the opportunity cost of giving up positive carry in the swap or the direct cost of purchasing downside protection outweigh the risk reduction achieved through the hedge? If the hedged risk does materialize, then did you hedge enough?

It is critical to base your hedging decisions on a sound strategy containing several important elements:

- A thorough identification of all interest-rate related exposures including funded debt and other potential risk sources such as asset-based borrowing facilities, off-balance sheet leveraged leases and unutilized revolver commitments.
- An optimal risk profile quantified and approved by the board. For example, the company may have determined that the risk of interest expense in any future year exceeding a benchmark cannot exceed a certain number of standard deviations.
- A framework that quantitatively determines what types of hedges provide the best economics and are consistent with the target risk profile.
- A disciplined process to continually review the risk profile against the target and take appropriate hedging actions.
- A cross-functional understanding of the relationship between the hedging objectives and accounting objectives under FAS 133.

2. Optimize the Capital Structure

A higher interest rate regime changes the optimal mix of debt and equity in the capital structure. With leverage more costly, it may be time to scale back the share repurchase program or incorporate more equity financing in the strategic growth plan.

Don't assume that the optimal debt level means less, however. Take a closer look at your capital structure to make sure the company has achieved the optimal tradeoff between the benefits of leverage and the flexibility of equity. Treasury is in the best position to perform this evaluation since the capital structure and risk management strategies are more effective if developed in unison.

Consider the example of the company that evaluates its interest rate risk profile based on probabilistic outcomes of interest expense. Current and future debt levels will greatly impact the stress test results. Conversely, a rigorous liability management model to identify the optimal level of debt in the capital structure will capture the benefits of an effective risk management program.

3. Take Out Working Capital

Our equations demonstrate that raising the cost of capital reduces the company's stock price by increasing the capital charge component of EVA. This points to a solution: reduce the level of capital to offset the higher cost. Challenge the level of working capital in the organization:

- Is the billing cycle compressed?
- Is the collection process disciplined?
- Are payment terms being optimized?
- Depending on the organizational structure of the company, these may be areas beyond the scope of treasury. But rising capital costs mean it is time to step up to the plate. While many working capital-related processes may be controlled outside of treasury, the treasury department is in a unique position to understand and quantify the benefits of effective working capital management.

4. Sharpen Cash Management

A core responsibility of the treasurer is managing the cash well. With short-term rates on the rise, cash managers need to be concerned about excess cash balances. It is time to renew the focus on perennial liquidity management issues:

- Is cash positioning fine-tuned? Is the company optimizing the tradeoffs between ECR, sweeps and active investing? Is the bank account structure streamlined to avoid trapped cash? Is the company effectively bringing home or investing offshore cash?
- Is backup liquidity optimally sized? Could it be reduced?
- Is the cash forecasting process accurate? How much liquidity is being held in reserve to provide a cushion against unanticipated outflows? How much cash is not invested effectively because its receipt was not planned?

A regime of high interest rates brings challenges and opportunities. Developing solid hedging strategies, determining the optimal capital structure, reducing working capital and tightly managing cash are strategic issues. Treasury, with its stewardship of the cost of capital, is uniquely positioned to create tremendous value for the company in an era of high capital costs.

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