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If Rates Ever Rise, Hedging May Come In Handy

By Julie Bennett

For the last decade, you were considered a financial genius if you had simply borrowed money with a floating interest rate. That may still be the case with all the talk about negative rates, but we think rates are close to the bottom. The smartest borrowers have to know about interest rate hedging and terms like swaps, caps and collars.

"At the end of the day, it comes down to how much risk most banks will allow a borrower to take, and today a loan with a 100% floating rate looks too risky," says Rick Thompson, managing director of BMO Harris Bank's Franchise Finance Group in Irvine, Calif.

Cristin O'Hara, managing director and group head of Bank of America Merrill Lynch's Restaurant Group in Boston says, "While we don't insist on hedging to do a deal, we strongly suggest that borrowers use a hedging strategy for half of their funded debt."

Floating rate loans, as we learned so well during the past several years, are great as long as interest rates are low, but become expensive when rates rise. Just ask anyone who had a variable rate loan in 1980 when rates shot up by 12% from June to December. Fixed-rate loans take away market risk but they are more expensive. "Ten years ago," says Thompson, "accepting a fixed rate of 9% seemed prudent, but those borrowers were sorry when rates fell."

By hedging, you can lower your risk and take advantage of a volatile market's upside. The hedge used by most multiunit franchisees that borrow $10 million to hundreds of millions, says Robert Daniel, managing director and head of the restaurant bank group of Regions Bank in Atlanta, is an interest rate swap. In a swap, you trade a portion of your fixed interest rate with a borrower of a sum who has a floating rate, or vice versa.

"Swaps work like the stock market," says Daniel, "with traders who make a market between buyers and sellers." Your swap request will go into a huge global marketplace, he says, and your trading partner may not be another restaurant company, but manufacturer thousands of miles away. Swaps, like other financial derivatives, can get exotic. "You can buy a swap today that does not start for 12 months," Daniel says, "or even sell an attractive swap and make some money.

But the vast majority of our restaurant clients prefer plain-vanilla swaps, that is, swapping out half their interest rate for the opposite type."

In a swap, your principal never moves, but you make two interest payments, one to your original lender and the second to the entity that represents your trading partner. Swap fees are negotiated with your banker and are embedded into your loan payments. If you want to add some more debt, you can extend the maturity of your loans and swaps in a strategy called "blend and extend," says O'Hara.

However, "before you agree to a swap, you need to do your homework," warns **Chris Kelleher,** managing director of **Auspex Capital**, a Los Angeles-based investment banking firm. While there is no upfront, out-of-pocket cost when purchasing a swap, he says, if it is not structured correctly, it can cost franchisees in terms of higher interest rates over the life of the swap.

There are many factors that go into how swaps are priced, but there hasn't been a lot of transparency on swap pricing, he says. "Lenders and their capital markets desk are important resources to help navigate through the process," Kelleher added, "but it is important to remember that selling swaps is a profit center for the banks" and there might not be a complete alignment of interest between the bank and the borrower.

He advises borrowers tap their company's CFO, CPA, outside money manager or a third party consultant to learn more about this market to ensure they don't pay for more protection than they need.

A generally simpler and often less costly hedging strategy uses interest rate caps that work much like term insurance policies. When negotiating a floating rate loan, you can pay an upfront fee to set a maximum interest rate ceiling, says Thompson.

With a cap set at 8%, for example, you don't have to worry about rates going up to 9%, because the holder of the cap pays the difference. If rates stay below 8% for the duration of your loan, you forfeit your entire fee, just the way you would if you outlived a term life insurance policy. Unlike swaps, which are usually arranged by your lender, you can buy caps from other banks and because of that competition, your lender is often more competitive with its cap pricing than it is with its swap pricing, Kelleher says.

An even less expensive hedging strategy is called a collar. For a lower fee, says Larry Kalis, a director in the rates and currencies origination group at Bank of America Merrill Lynch, "you can combine an interest rate floor and an interest rate cap to create an interest rate 'band' within which your cost of borrowing floats." As with caps, the holder pays any interest that exceeds your maximum rate, but collects the difference from you if rates fall beneath your floor.

Joey Pierson, vice president and CFO of a multiunit franchise company in Birmingham, Ala. with two brands —Tacala, with 272 Taco Bells, and Boom Foods, with 66 Sonic Driveins—says, "We began swapping in the late 2000's with a goal of being about 50% fixed and 50% floating. Since 2012, when Altamont Capital became our majority owner, we have used a series of caps and swaps to hedge about 80% of our debt. We don't have to worry about interest rate changes and this makes it real easy to predict cash flows."

Most of all, says Brian Frank, senior vice president of TD Bank in Wilton, Conn., interest rate hedging provides peace of mind. "Our operators would rather focus solely on running their businesses and taking care of their customers than worrying about what's going on with interest rates," he says.

—Julie Bennett