CONTESTANT:
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THIS MONTH'S CHALLENGE: Swapping out

THE CHALLENGE:
Private Equity Holdings ("PEH") is required by its charter to avoid companies that use derivative financial instruments to speculate. In reviewing numbers for FAS 157 reporting purposes, a PEH managing partner notices that one of its portfolio companies, ABC Incorporated ("ABC"), recently included a FAS 133 entry for a $20 million interest rate swap hedge. During a call to the company to query about how the swap is being used, the PEH managing partner is informed that its counterparty is Global Bank Limited ("Global"). Not only has Global just reported a $30 billion loss due to poor valuation of its structured product portfolio, it posted no collateral in favour of ABC while ABC was required to pledge $2 million in US Treasury Bills in order to protect Global in the event that ABC could not make its contractual swap payments to Global. Not being too familiar with derivative instrument pricing and default risk analysis, PEH hires an expert to investigate whether the swaps reflect a hedge versus a market bet and to further assess how PEH should adjust the valuation of its equity stake in ABC. What does the expert need to look at and how should she arrive at an appropriate conclusion?

SUSAN MANGIERO'S ANSWER:
This fact situation, ripped from the headlines, raises several important valuation questions, including, but not limited to, the following:

- Notwithstanding FAS 133 numbers, is the company exposed to changes in interest rates that could adversely impact cash flow, liquidity and net income?
- Was the swap correctly valued?
- How might ABC be impacted by Global's deteriorating health?
- What adjustments, if any, should PEH make to its initial valuation of ABC equity?

There are several critical issues here, all of which could seriously hamper the fortunes of both ABC shareholders and PEH investors. An inaccurate valuation of the swap leads to a flawed accounting representation for ABC and may lull treasury staff into thinking that the hedge offers full protection against unexpected moves in interest rates. PEH may report a bad FAS 157 number which in turn could lead to flawed asset allocation decisions made by institutional limited partners or the overpayment of performance fees to PEH. A poorly constructed hedge (in economic versus accounting terms) that exposes ABC to negative market conditions could force PEH to violate its prohibition against speculative trades being executed by portfolio companies. If Global does not meet its swap obligations and/or files for bankruptcy protection, ABC may not be able to recover its collateral quickly or could lose it altogether, depending on its standing vis-à-vis other creditors.

Swap pricing models can differ depending on the complexity of the transaction. However, for standard fixed to LIBOR swaps, the secondary market is large ($111 trillion, according to the Bank for International Settlements). Active trading makes it easy to readily obtain prices for various maturity interest rate swaps with quotes reflecting the discounting of future projected fixed and floating swap payment amounts. In contrast, the assessment of credit worthiness varies, sometimes considerably, across banks. Unfortunately for ABC, even if they posted more collateral than should have been required, the fact remains that they have no immediate recourse in the event that Global's distress prevents the bank from paying what it owes to ABC. If Global defaults, ABC will then have to decide on a course of action that could include any or all of the following:

- Enter into a second interest rate swap to replace Global at a now higher fixed rate
- Attempt to sell the initial swap in the open market and consider another way to hedge against rising interest rates, though few will be willing to accept the Global risk
- Take legal action to reclaim its collateral
- Write down the value of the swap on its books

There is no ideal situation. The expert will necessarily have to ask ABC what they plan to do in the event of swap non-performance and how it is expected to impact its cash flow, cost of money (which in turn affects capital budget decisions), balance sheet, dividend payments and interest coverage. Once that scenario analysis is conducted, both the expert and PEH will be able to quantify how much of an adjustment downward they will need to make for both accounting and performance reporting purposes. ■