Pre-Issuance interest rate risk management enables companies with future debt capital needs to put in place a strategy and execute meaningful hedges to mitigate the risk of increases in future borrowing costs.

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Forward debt capital needs take on a variety of forms. Some of the most common include the funding of merger and acquisition activity, future capital expenditures or projects, converting current bridge to permanent debt capital, and the refinancing of up-coming maturities of debt obligations that may have a bullet or balloon payment. The debt capital associated with these needs may be raised in a variety of capital markets, but is commonly priced off a benchmark US Treasury yield, swap rate, or variable rate.

Prior to the pricing of these debt facilities, companies are exposed to movement in these respective benchmark rates, potentially eroding the positive benefit of initiatives or just generally decreasing shareholder returns.

A pre-issuance interest rate risk management strategy and hedge allows a company to evaluate, lock in, or purchase the right to lock in rates today for an anticipated date, thus providing a degree of certainty for the company’s future interest rate and related expense.

Once a company has a reasonably certain expectation of a forward debt capital need, it can evaluate the most appropriate hedging tool, how much of the projected capital need should be hedged, and the timing of when those tools will be put in place.

The most common tools utilized to manage pre-issuance interest rate risk include the forward starting swap, the treasury lock, and the interest rate swaption.

Forward starting swaps and treasury locks provide the user the benefit of locking in rate benchmarks associated with future debt financings. This provides a meaningful mitigation of increases in future cost of capital. These strategies are executed today to be effective at a predetermined future date (effective date) which ideally matches the anticipated issuance date of your future debt financing.

If interest rates are higher on the effective date, the company receives a settlement, which offsets the higher benchmark related to the actual underlying financing. If interest rates are lower on the effective date, the company pays a settlement, in effect offsetting the lower benchmark related to the total underlying financing. Important to note, these tools create a firm commitment to pay or receive a settlement based on future interest rates even if the underlying financing does not
actually occur.

Another alternative, the interest rate swaption, allows a company to purchase the right but not the obligation to enter into an interest rate swap at a future date. Unlike the forward starting swap and treasury lock, the swaption is not a firm commitment.

This means that following the delivery of the upfront cash premium, entities utilizing this strategy have no further obligation to make a settlement. This creates an asymmetric payoff profile whereby users are protected against higher interest rates due to receipt of a cash settlement at issuance, but their downside risk is limited to their initial premium paid.

The amount of future debt capital hedged is evaluated differently across corporate management teams. The pre issuance hedge amount may be based on several inputs including portfolio theory, management style, management’s market perception or view on future interest rates, and the extent the cost of capital lever adversely impacts the company’s viability.

Although many companies evaluate and utilize these strategies in many interest rate environments, market participants may argue an ideal time to execute a pre-issuance hedge would be when nominal benchmark rates are low or below their historic averages, are expected to rise, and the forward or cash premium associated with these hedging tools is historically low.

In the current interest rate environment, the markets exhibit a number of these key characteristics. As you can see in the chart, nominal Treasury Yields across several maturities remain well below historic averages.

Additionally, economists and market participants are forecasting a gradual rise of interest rate benchmarks due to continuing strength in the US economy, a tightening labor market, and eventually, a return of inflationary pressures following the recent softening related to the strong US Dollar and sharp drop in oil prices. Finally, due to similar factors, the forward premium, defined as the difference between today’s interest rate benchmarks and their future peer’s, remains well below historic averages.

Ultimately, the best pre-issuance interest rate risk management tool, strategy, and timing for companies is the one that balances the mitigation of market risk and cost to a level an issuer finds tolerable.

Should you have any questions or if you would like further information, please contact me utilizing the information on the next screen or reach out to your local PNC Derivative Products Group partner.

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