**Note on further hedging**

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Hexagon’s Treasury Management Policy statement defines treasury management activities as follows;

“The management of the organisation’s cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.

Unlike many RPs Hexagon has put in place a treasury policy that reflects both legs of this definition. The policy in the first instance aims to control risks associated with the cash flows of the business. It does this primarily by creating certainty by fixing the interest rates on its borrowings. The policy also requires Hexagon to manage risks at the same time as seeking optimum performance consistent with those risks.

This is the essence of the conundrum facing Hexagon. Hexagon could eliminate all interest rate risk by hedging 100% of its debt. However as fixed rate debt is almost always more expensive than variable rate debt this course of action would not lead to optimum performance.

Hexagon has therefore adopted a strategy of determining the amount of exposure to interest rate risk it is prepared to accept by reference to its business plan and specifically the interest cover covenants set by its lenders. The logic being that if these covenants are breached the lenders will increase the credit spread on loans which would clearly not be consistent with pursuing optimum performance. If the business plan demonstrates that the level of hedging in place is sufficient to prevent such breaches occurring, further hedging which increases borrowing costs can be avoided and performance optimised.

Hexagon has demonstrated through its stress testing that the business plan can sustain Libor increasing to 13% before interest cover covenants are threatened. On the face of it this suggests that there is no need for Hexagon to undertake any further hedging.

However, Treasury Policy is set by boards to guide the decision making processes of an organisation, not as commandments that shall never be broken in any circumstances. It is best practice for organisations to review policies on a regular basis and for the recommendations and strategies to be subject to a “sense check” taking into account the prevailing environment.

Hexagon, in common with all RPs is facing an interest rate market which, as a result of a number of extraneous and endogenous developments has produced unusually low fixe interest rates across the yield curve.

The chart below shows the swap yield curve today compared with one month and a year ago.

As can be seen the difference between short term interest rates and long term interest rates has fallen dramatically. A year ago 3 month Libor stood at around 0.5% compared with 30 year swap rates at just under 3.5%. A difference of just under 3 % compared with a current difference of about 1.5%. At the shorter end (5 year maturity) the differential has also fallen to just under 1 % compared with about 1.5% a year ago. In other words the loss of “performance” resulting from reducing interest rate risk by fixing has fallen significantly.

Capita is therefore comfortable in advising Hexagon to consider entering into further fixes.

Based on the above it could be argued that the greatest certainty would be obtained by entering into longer term swaps. However there are a number of reasons why we continue to advise clients generally against entering into longer term stand-alone hedges with banks. These are;

* Mark to market exposures on long term swaps are more volatile
* Trading spreads taken by banks on tend to be higher
* There is a greater risk that long term bank debt will be refinanced
* Future borrowing is more likely to be in the form of long term fixed rate bond debt

In conclusion we consider that given the current very low fixed rates of interest currently achievable, it would not be inappropriate for Hexagon to consider entering into some further interest rates hedging. Specifically Hexagon has a £5 million hedge with Lloyds that matures in 2016. A new forward fix could be arranged to extend and or increase this contract. A ten year term on this fix would provide further protection out to 2026.

The amount of further protection is a matter for consideration by the Board and the Executive. The business plan rightly includes some very conservative assumptions on future interest rates. Many forecasters, now including the governor of the Bank of England are forecasting that interest rates will remain much lower that in the past as and when they start to increase. Retaining variable rate debt may result in lower future borrowing costs, and therefore better performance, than the fixed rates currently achievable as opposed to the fixed rates assumed in the business plan.

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