

## WACC: Practical Guide for Strategic Decision-Making - Part 4: The Impact of Corporate Risk Management on Shareholder Value



*THIS PART LOOKS AT HOW RISK MANAGEMENT IS AN INSTRUMENT THAT CAN BE USED TO LOWER THE WACC AND CREATE SHAREHOLDER VALUE.*

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This part looks at how risk management is an instrument that can be used to lower the WACC and create shareholder value.

In a perfect financial world, risk management would be irrelevant for shareholders with regard to shareholder value. Risk management would not add any value in this perfect world because each participant would have equal access to the capital markets and there would be less financial distress. This scenario is the so-called Modigliani-Miller world in which the shareholder would be able to achieve the same value by applying their own hedging strategy because they would have access to the same information as the company and, as a result, no hedging cost.

The real financial world, however, is rarely as perfect as an academic model. Capital markets do suffer from imperfections, such as information asymmetries, agency costs, transaction costs and taxes. Because of these influences, hedging costs are lower in the case where a company hedges itself rather than when individual shareholders take the same action. It is therefore possible for a company to create shareholder value by professional corporate risk management in a way that is impossible for shareholders on their own.

### Ways to Add Value with Risk Management

The objective of risk management for most corporates is to reduce the influence of external financial variables on the company's earnings volatility (in the short term). The financial variables for which the treasurer is responsible normally include interest rates and foreign exchange rates but can also include

commodity prices, inflation levels or even the outside temperature.

This article will show how risk management can add shareholder value by means of lowering the WACC by breaking down the WACC formula into the different components where the risk-free rate and market premium are taken as given (Part 1: Is Estimating the WACC Like Interpreting a Piece of Art?). In its basic form the WACC formula is:

$$WACC = R_D * \left[ \frac{D}{D+E} \right] * [1 - \hat{o}] + R_E * \left[ \frac{E}{D+E} \right]$$

D: Market value of interest-bearing debt

E: Market value of common equity

$R_D$ : Cost of interest-bearing debt

$R_E$ : Cost of common equity

$\hat{O}$ : Corporate tax rate

The article will also look at the relationship between risk management and the cost of equity, cost of debt, effective tax rate, and optimal leverage.

1. Lower the cost of equity by lowering the beta of the company

A risk reduction leads to a reduction in the required return of the shareholders. Obviously, lower required returns on equity are not value creating in their own right but when combined with the other effects on the WACC, as described below, they offer possibilities to increase shareholder value.

2. Lowering the cost of debt

The cost of debt is based on the prevailing market rates plus a company-specific credit spread.

The relationship between the cost of debt and risk management is twofold. First, with regard to interest rate risk, one of the objectives of corporate risk management is to lower the absolute interest cost. This can be done in a tactical way by active interest rate risk management where the objective is to reduce the nominal interest expenses and thereby the cost of debt. Secondly, the outcome of active interest rate risk management affects the cost of debt of a company. The cost of debt and especially the company-specific credit spread are determined, among other factors, by cash flow and accounting ratios. As risk management focuses on the mitigation of cash flow and earnings volatility, the ratios derived from cash flow and earnings will also be less volatile. Lower volatility in ratios and cash flows are perceived as positive by lenders. This means that lenders will subsequently lower the credit spreads and increase borrowing possibilities for the company.

### 3. Lowering the effective tax rate

The value of a company increases when the tax shield related to debt exceeds the cost of financial distress that is associated with debt. A combination of annual volatility in stock returns and leverage of the company determines the expected value of the tax shield. High financial leverage and earnings volatility will lead to lower expected values of the tax shield. As a result, the shield produces fewer profits because of a loss in time value from loss carry forwards. With risk management, a company can influence and control the annual volatility of stock returns and this allows the company to increase the expected value of the tax shield. The relationship between the WACC and taxes will be discussed in more detail in Part 7 of this guide.

### 4. Increasing optimal leverage

Professional risk management increases the shareholder value of the company: it lowers the credit spread and the cost of equity, and increases the expected relative tax shield. All these factors will result in an even larger benefit of risk management, which is the possibility of increasing the leverage of the company. The combination of lower required return on equity and a lower effective cost of debt can help to provide the option for a company to increase its leverage. As shown in the first two articles of this guide, increasing leverage to an optimal point creates shareholder value.

## Trend in Risk Management

An integrated, proactive and quantitative approach to risk management is the latest trend in the financial markets. Increasingly, companies make use of systems to quantify the market risks their companies face and use this information for decision-making at a strategic level. Most risk management today is aimed, primarily, at hedging transaction exposures. Few companies actively hedge interest rate exposure and FX translation exposure and an even smaller group of companies are also hedging their total economic exposure including, for example, commodity price risk.

In order to lower the earnings volatility, companies should focus on all the financial variables influencing the earnings and profitability of the company in the mid- to long-term. Useful methods to measure and manage those risks are cash-flow-at-risk or earnings-at-risk models. Current accounting rules (IAS 39 and FAS 133), however, motivate companies to pursue a risk management strategy that is primarily aimed at short-term earnings stability and makes it more difficult to hedge economic risks in order to minimize earnings volatility. If the economic hedges do not comply with hedge accounting standards then the fair value changes of the hedges are going through the P&L of the company, resulting in increased earnings volatility. This, of course, is quite the opposite of what a company engaged in risk management wants.

## Committed Capital as an ART Form

As discussed in part one of this series, companies tend to maintain a sub-optimal WACC (left on the WACC curve) with a lower than optimal leverage. A reason for this is that they want to prevent a situation of financial distress due to unforeseen events. To avoid this, companies maintain a higher than necessary credit rating and WACC in order to prevent themselves from moving towards the 'right side' of the optimum level. When a company finds itself in a position of financial distress, it is relatively difficult to get back to the optimum level. Debt, as well as equity, will be more expensive and difficult to issue in this scenario.

Alternative risk transfer (ART) products can prove to be a useful instrument in optimizing the financial structure and WACC of a company whereby the above-mentioned risk of financial distress is mitigated. ART products enable companies to transfer risk in a non-traditional way by creating new possibilities to issue capital when pre-determined events occur. An example of an ART product is committed capital, which is an option purchased by a company to issue capital, either debt or equity, if a pre-determined outside event occurs.

Take, for example, a manufacturing company that is exposed to high fuel prices. The increased fuel price cannot be set off by its clients so the increasing prices have a direct impact on the earnings, and indirectly on the equity of the company. To avoid the possible resulting financial distress, the company can buy an option (the committed capital product) to issue equity at pre-determined prices when average fuel prices are above a defined trigger level during a certain period. By issuing the equity, the company can restore the required WACC and credit rating and prevent financial distress.

Committed capital usually involves the payment of a fee (option premium) to the capital supplier from the company seeking capital in exchange for which the capital supplier agrees to supply paid-in capital on fixed terms based on a date in the future. Committed capital is therefore a form of contingent capital with

an option on paid-in capital. Because of this optional characteristic of the instrument, contingent capital can in some cases have the advantage of being an off-balance sheet type of capital.

Like all sorts of capital, committed capital comes at a cost. The cost and benefits of the product have to be carefully examined and taken into account when evaluating a move into this type of financing. When conditions are right, committed capital will have a positive effect on the company by lowering the WACC. With the developments in ART products, there is convergence in capital and risk management products.

### **Conclusion**

Corporate risk management has a positive impact on

shareholder value, which can generally be increased by reducing the WACC and/or by enlarging expected cash flows. We have seen in this article how risk management can help a company to lower their WACC by lowering the cost of equity, lowering the cost of debt, increasing the expected tax shield and unlocking the possibility for a company to increase its leverage with debt.

Furthermore, accounting regulation can motivate a company not to hedge, even though this would be desirable from an economic point of view. Finally, committed capital as a form of ART products was highlighted as an instrument for a company to increase its leverage without running the risk of moving towards the undesirable 'right side' of the WACC curve.

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