

Evaluating the Risk in Below LIBOR Funding Alternative

The CFO of a large US corporation (XYZ) approached us recently for advice on how to evaluate the following two alternative financing methods..

XYZ Corporation is rated BBB by S&P and is considering alternative methods for funding short term financing needs. Currently XYZ is financing through a \$200 million 6 month bank loan and rolling it over every six months. The interest rate is LIBOR plus 150 bp.

XYZ's investment banker has suggested the following two alternatives.

- (a) Issue a 5 year coupon bond through private placement. Swap the fixed coupon payments for floating in the swap market
- (b) Issues a 5 year bond, callable after 24 months by private placement. Swap the fixed payments for floating in the swap market through a cancelable swap.

Under either alternative XYZ will pay floating – as under the current bank loan arrangement. The investment banker recommended alternative (b) based on the market conditions that prevailed at that time.

In this project you will gather current market information on bank loans, straight and callable bond rates, rates for plain vanilla and cancelable swaps, and issue costs. You will then analyze the costs, benefits, and risks to XYZ of the different alternatives.