

Liberty Travel

It was early March, 1993. Chris Spence, an account manager at Nationsbank's New York office, had just concluded a phone conversation with Maxine Letaconnoux, Treasurer of Liberty Travel. Spence had been discussing the possibility of hedging some of Liberty's financing costs for the forthcoming year. Liberty Travel was a privately-held chain of travel agencies specializing in European and Asian business travel and vacation packages. Although Liberty was a client of long standing, Chris had not yet met Maxine face to face. She had recently been transferred from general administration to replace the previous Treasurer, who had been let go as a result of cutbacks that Liberty had been forced to make in 1992. The recession of 1991-1992 had had a severe impact on the travel business, and Liberty's earnings had suffered.

In 1993 and 1994, however, the management team at Liberty Travel was anticipating a stronger market. From the Treasurer's point of view, the plus was that she was likely to keep her job. The negative was the possibility of higher interest rates as the economy picked up. Liberty had \$12 million in fixed rate debt as well as a \$30 million line of credit, priced at 1.85% over 3 month Libor, with Nationsbank. The company expected to fully utilize this line during the forthcoming year.

Letaconnoux, Chris had learned, was interested in hedging against the risk of rates rising, but like many such clients was reluctant to pay any fees and, being new to the job, was suspicious of complex financial instruments.

The following possibilities had been raised during the telephone conversation:

1. Convert the Nationsbank line into a 3-year fixed rate term loan at 8.85%
2. Fix Liberty's cost of funds by means of a 3-month FRA (a forward rate agreement), starting in three months, i.e. in June.
3. Fix Liberty's cost of funds by means of an interest rate swap. The 3-year swap rate was 6.97%.
4. Hedge against rising interest rates using interest rate futures.
5. Do nothing at present, because if the economy were to remain weak and interest rates fell even further, paying a fixed rate could place Liberty at a competitive disadvantage.

In preparation for a visit to the firm the next day, Chris decided that he should succinctly compare the costs, risks and benefits of the different approaches to interest rate risk management.

Liberty Travel (cont.)

Exhibit 1. Current Interest Rates

Prime Rate: 8 1/4%

Eurodollar Interest Rates

| | | | |
|----------------|----------------|-----------------|------------|
| 1 month | 3 months | 6 months | 1 year |
| 5 1/4 - 5 7/16 | 5 7/16 - 5 5/8 | 5 11/16 - 5 7/8 | 6 - 6 3/16 |

3-Month Eurodollar Futures Contracts (IMM) \$1m points of 100%

| | Open | Settle | Change | High | Low | Volume | Open Interest |
|-----|-------|--------|--------|-------|-------|--------|---------------|
| Mar | 94.14 | 94.21 | +0.07 | 94.27 | 94.11 | 76,859 | 411,868 |
| Jun | 93.82 | 93.93 | +0.11 | 94.02 | 93.79 | 86,706 | 440,381 |
| Sep | 93.67 | 93.80 | +0.13 | 94.00 | 93.62 | 79,942 | 293,293 |

Treasuries and Swaps

| | Treasury Bills and Bonds Yields (semi-annual) | Interest Rate Swaps Spreads over Treasury (basis points) |
|---------|--|--|
| 3 month | 5.26 | |
| 6 month | 5.50 | |
| 1 year | 5.74 | 45-48 |
| 2 year | 6.21 | 46-50 |
| 3 year | 6.40 | 52-57 |
| 5 year | 6.59 | 53-58 |