The financial analysis of barcelona brasseries

Finance

CASE STUDY: BARCELONA BRASSERIES

Executive Summary

The report is a summary of the financial analysis of Barcelona Brasseries S. L. It entails an assessment of the possible benefits of hedging interest rates, as suggested by the private banker, given the existing economic environment. Emphasis is given to the specific features of the family's debt repayment profile that is provided.

Question 1

Hedging of interest rates through the application of derivatives may be a very effective method of retaining mortgage loans. Hedging entails transferring some risk to a different (third) party. The success of hedging is only attainable if the correct strategy for the credit union's profile is well understood. In the case study, hedging, as suggested by the private banker, would make sense for Barcelona Brasseries S. L. The economic environment is characterized by floating interest rates all through, with low margins. Given the prevailing economic environment, hedging the interest rates may be beneficial. The prevailing interest rates are low, and the company's investment yield is quite low. Since the company has recently obtained additional locations all through Barcelona, for 1, 000, 000 Euros holding mortgage loan(s) will, therefore, result in higher earnings. Such a rise in income is caused by the increased interest earnings. In the example provided, the interest rate –swap has been set into a three-month floating rate system. The three-month floaters stretch more than it can if invested in securities and there are no capped rates (Hollis 2011). The company's performance will be better if the interest rates increase. Suppose the rates fall, the three-month floater will have a performance similar to that which was predicted. However, the low rate ma be quite inconvenient.

Deventer and Imai (2013, p. 113) note that there are some dangers the family may have to take into account when implementing the hedging of interest rate risks. There is a need for constant and consistent rearrangement. For example, a hedge with an eight percent effective duration would be sufficient to hedge a balance sheet with 31-year mortgage loans. However, seven years later, the hedge diminishes ineffective duration and may need to be rearranged with more hedges as the earlier former hedges mature. In most cases, this rearrangement needs superior modeling methods.

In summary, the hedging of interest rate risk and the application of derivatives are useful method Barcelona Brasseries Inc. may consider utilizing. It is suitable for the company, going to the prevailing economic conditions (floating interest rates and low margins). Even though hedging may be considered advantageous to the family for selecting the credit unions' asset/liability management strategies in the future, it needs a great deal of additional work and education. It requires multifaceted tools with accounting rules, which are quite difficult to understand and implement (Deventer & Imai 2013, p. 117). They can, however, be worth the extra effort for credit unions that need them.

Question 2

Various interest rate hedging strategies may be used effectively by Barcelona Brasseries as discussed below. Since Barcelona Brasseries, just like many organizations including the federal agencies are not allowed to trade in futures, they can make good use of swaps to manage their duration risk. Swaps cost low and can be tailored to fulfill the business requirements, in situations where futures are exceedingly normalized. When using swaps as a hedging strategy, the initial value of the swap should be kept at zero. The fixed rate should be more than the rate on default-free treasuries. Interest collars may also be used effectively by the family to hedge interest rate risks that come with the holding of bonds (Hollis 2011). Usually, the prices of bonds fall as the interest rates rise. The interest rates cap can, therefore, provide assurance for a maximum fall in the value of bonds.

Question 3

The following is an ad-hoc solution, designed and recommended to the Barcelona Brasseries family. Since every investor can use credit default swaps to get exposure to credits, the family can customize their exposure by specifying the terms, like notional amount, products or strategies, underlying, protection rate and currency. These terms are quite flexible, and protection can be traded to yield more portfolio income. Contrary to a cash bond where an investor expects or receives credit and duration exposure, a CDS is a pure credit play (Hollis 2011). Product contracts may represent the minutest amount of notional OTC. Barcelona Brasseries may utilize structured notes that are linked to commodities index to enable investors define their downward exposure. It will help them reduce the risk involved.

Bibliography

Deventer, D & Imai, K 2013, Advanced financial risk management tools and techniques for integrated credit Risk and interest rate risk management (2nd ed.). New York: Wiley.

Hollis, 2011,‘ Hedging Interest-Rate Risk: How and when to go about it’, CFO Focus, vol. 34 no. 6, retrieved 5 March 2015,