BY AARON McFARLAND & JUSTIN FISHER

Protecting Liquid Investments in the Face of Interest Rate Hikes

For years, consumers and businesses alike have been concerned about the likelihood of a rate hike and what it might do to their finances, but few groups would be more profoundly impacted than contractors.

Hefty backlogs and broader margins are good news for the industry, but working at full-tilt comes with an acute need for capital to fund growth. For contractors in particular, capital often comes from financing – hence the anxiety surrounding the potential change in interest rates looming on the U.S. economic horizon.

With this eventuality in mind, contractors should start thinking about and planning for their liquidity needs now. By prudently managing investments so they can be used to generate needed cash if financing becomes more expensive, contractors will be poised to not only overcome the challenges of a rate hike but also seize opportunities their competitors can't.

Overview of Current U.S. Monetary Policy

Monetary authorities, including the U.S. Federal Reserve (the Fed), influence interest rates by buying or selling short-term government debt.

Lowering interest rates stimulates economic growth by incentivizing companies to take on debt, which they use to fund hiring and expansions. On the other hand, increasing interest rates raises the cost of debt and discourages businesses from using credit to expand, which curtails growth and lowers inflation. (Refer to Exhibit 1 a few pages ahead.)

Unfortunately, the current increase in the global money supply hasn't led to widespread inflation. Therefore, the Fed must now attempt to raise interest rates (so it can lower them to combat the next economic recession) without causing a separate recession resulting from low inflation and slow wage growth. The most recent increase occurred in December 2015, when the Fed raised the interest rate by a quarter of a percentage point to a range of between 0.25 and 0.50%.

Depending on the Fed's next steps, several possibilities exist as presented on the next page, and the stakes are high for any decision it makes. This article will examine how contractors can position themselves for success regardless of what the future holds.

Prepare for the Worst, Hope for the Best

Since interest rates will ultimately increase, take steps now to become less reliant on lines of credit and turn your untapped cash reserves into a resource that can later offset a higher cost of borrowing.

How to Adjust Your Allocations

1. Review Current Exposure

Review the liquidity, maturity, and titling of the liquid assets on your company's current balance sheet. If it solely holds cash, then this may be an easy process; however, many contractors maintain other items, including certificates of deposit (CDs), money markets, and single-security stocks or bonds. Once you've taken inventory of these assets, assess the current level of exposure to varying economic conditions (e.g., market events, interest-rate movements, and inflation changes).

Assets likely to be susceptible to interest-rate movements include fixed-income assets, such as corporate municipal bonds, which can see large swings in value based on interest rates. Typically, the longer the maturity, the more susceptible it is to rate movement.

2. Analyze Your Business Cycle Cash Flow

To better understand how to position your company's liquid assets moving forward, gather data showing how cash is affected over an economic cycle. Cash ebbs and flows as it's needed for projects, shareholder payments, etc.; review your balances over time to determine the frequency and depth at which cash was used throughout a business cycle.

Consider Exhibit 2 a few pages ahead as an example of a contractor's cash reserves over a 24-month business cycle. It shows three separate categories:

Potential Interest **Rate Change Scenarios & Effects on Contractors**

Scenario A: Interest Rates Rise Too Much & Too Quickly

In short, a steep and fast increase would likely cause a recession. In the very near term, an aggressive hike in interest rates would balloon national debt, and policymakers would have to stimulate the economy through fiscal spending programs such as issuing Treasury debt supported by quantitative easing.

Effect on Contractors

The availability of credit is a key concern in this scenario; limited credit could result in canceled contracts and reduced backlog. Interest rate movements often rapidly impact banks' lending rates, and because contractors typically borrow at a variable rate (standard for short-term financing), federal rate hikes could manifest quickly, making borrowing far less appealing.

As a result, contractors that rely heavily on lines of credit to complete work would see those higher rates negatively impact their cash flow.

Scenario B: Negative Interest Rates

In theory, negative interest rates motivate banks to lend money by charging them for holding onto it, which yields two possible outcomes. The intended result is an increase in credit growth, which stimulates overall economic growth and wards off deflation. However, both the European Central Bank (ECB) and Bank of Japan (BOJ) recently enacted negative interest rates, and their economies haven't responded as theorized.

Why not? First, banks would rather absorb the cost of negative interest than pass interest charges along to their largest depositors and risk losing them as clients. Second, a negative interest rate strategy assumes unmet demand for credit among borrowers – a demand that banks would have to meet by relaxing their underwriting standards. As seen in Japan and the European Union, either that demand isn't present or banks are unwilling to take on riskier loans.

Today, there's little appetite to purchase those bundled loans, so as a result, banks would rather forgo approving these loans than be unable to sell them later.

Effect on Contractors

Neither scenario comes without risk. If negative interest rates are implemented in the U.S. but fail to meet expectations, contractors can once again expect to see canceled contracts, reduced backlog, and lower revenue and earnings, along with an increased risk of reduced credit lines.

On the other hand, if negative interest rates expand credit as intended, then it may avert an economic crisis in the short term – but we won't be better off in the long term.

The bottom line: The long-term impact would be relatively the same regardless of the immediate results of negative interest rates.

Scenario C: Interest Rates Rise Slowly (Most Likely Outcome)

A slow rise in interest rates would likely cause annualized domestic growth of approximately 2.5% for the foreseeable future, characterized by low inflation.

Government spending is expected to increase in the coming years due to an aging demographic and related programs such as Social Security, Medicaid, and Medicare. This will increase the national debt, crowding out growth-oriented spending and constraining inflation.

The Fed won't be able to raise interest rates for fear of preventing growth, triggering a recession, or further growing the national debt. Increasing the national debt would likely lead to deflation.

As a result, it will take much longer to pay down, especially as the demographic changes.

Effect on Contractors

During slow economic growth, contractors would likely see their businesses follow the larger economic trend. Fewer construction contracts would be available, and margins would be narrower. As the government's discretionary spending dwindles, public projects will become more scarce, which could impact some sectors and companies more than others.

As interest rates rise, the cost of borrowing will slowly increase too. Though less urgent than if interest rates were to rise quickly, smart and deliberate asset management would remain an important way to offset increasing interest payments.

To start, determine how much cash you'll need on hand through your next business cycle. Then, assuming your lenders, sureties, and owners are comfortable with the change in your liquidity, invest amounts beyond that into income-generating securities.

- Near-term liquidity represents cash that's accessed several times during a business cycle (e.g., to pay for labor and supplies).
- Strategic reserves must be readily available, since that cash is usually accessed 1-3 times in a cycle. These funds would be used, for example, to lease specialized job equipment or fund other up-front costs for a large-scale project.
- Idle cash is longer-term liquidity permanently kept on the balance sheet; it's not used during a typical business cycle.

3. Project Your Needs Through the Next Business Cycle

Now that you have some past data, extend your weighted average cash line into the future. While you can't precisely predict the future, you can make some assumptions, such as:

- Capital needs based on anticipated capital project budgets and schedules
- Seasonal cash flow
- Awareness of adverse industry conditions on the horizon
- Access and use of leverage

4. Consider Third Parties

Determine how your leverage and liquidity structure currently affects bank covenants not only for the current environment, but also for one in which there is limited credit or bonding capacity.

If you have marketable securities available (identified in the first step), then it's critical to sit down with underwriters to understand how they discount various securities. With less idle cash on hand, your company could appear less liquid (and as a result, less creditworthy) if these conversations aren't held up front. Communicating a clear vision via an investment policy statement will help these third parties understand your plan, which can be instrumental in maintaining available credit.

5. Assess Ownership's Risk Tolerance

The last step in planning for a potentially unfavorable economic environment involves the softer side of business. In difficult markets or business cycles, individuals are more inclined to make emotionally motivated decisions about their investments and business.

Exhibit 1: **How Interest Rates Impact the Economy**

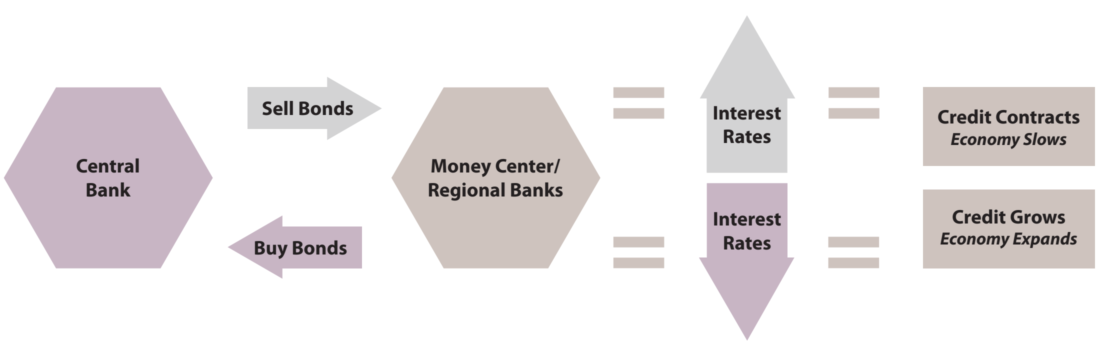
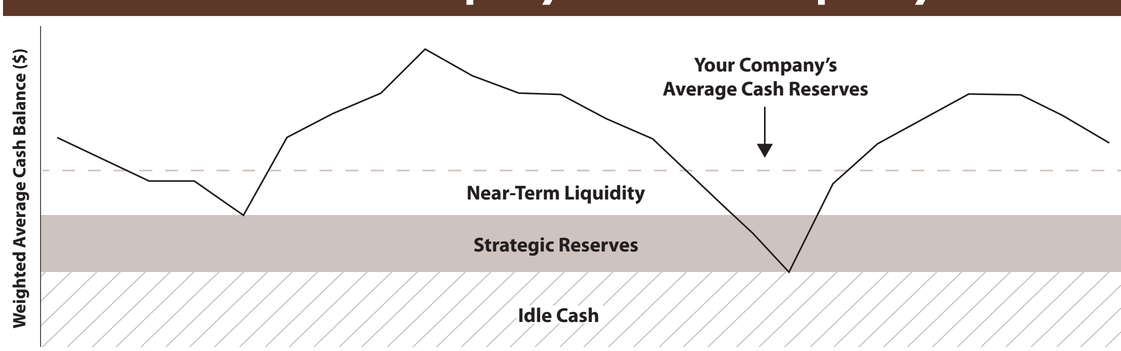


Exhibit 2: **Company Historical Liquidity Structure**



Talk with company owners now to create an investment policy and a decision framework for the months (and years) ahead.

This is especially important if the business is family-owned or has several owners. An accurate assessment of risk at the outset will create an objective set of rules that keeps everyone on the same page.

In the long run, it could potentially protect owners from business losses that can result from reactionary decision-making. Key questions to answer include:

- How do the owners of the business view the risk and reward trade-off, both in terms of their current liquidity structure and operations?
- How does your company's liquidity impact the personal financial planning of its owners, and should you consider outside assets if the business is family-owned?
- How can the owners diversify against other known risks?

Conclusion

The good news for contractors is that the same characteristics that will make them successful in a struggling financial market will also make them stronger today.

By following the five steps previously outlined, contractors will find they can rely less on credit, improve returns on cash reserves, and collect receivables more quickly.

Work with your advisor to develop a plan that satisfies your company's liquidity needs while delivering worthwhile investment returns to provide your company with flexibility and security regardless of what happens in the market. ■

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