

CBA Global Markets Research

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Abstract

This is a L^AT_EX writeup of my progression through a preponderance of alternative hedging strategies

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1 Case Brief

1.1 Problem Statement

You and your colleagues work in the Commonwealth Bank of Australia's Global Markets team. Your role is to help clients to navigate their financial market risks. Your client, Prime Property Trust, is concerned with the potential impact that movements in financial markets may have on their operations. The Treasury team at Prime Property Trust are particularly concerned about interest rate market movements and how it may impact their ability to meet budgeted cost obligations over the next year. The Treasury team wants to know:

1. Your view on inflation and the RBA cash rate and; how this will affect Australian interest rates.
2. The impact of variable interest rates to their business operations and cash flows; and
3. Financial market instruments that may be appropriate to manage these risks.

1.2 Background

Prime Property Trust is an Australian Real Estate Investment Trust (REIT) that manages and invests in a diverse range of property types, including office buildings and retail centres. Prime Property Trust primarily funds its assets with floating rate debt. Prime Property Trust has just announced two new assets to be added to the portfolio:

1. Price Corporate Tower (PCT) | | Facility tenor: 3 years | Size of facility: \$100m | Interest rate: 3-month BBSY+1.20%
2. Sterling Square (SS) | Facility tenor: 5 years | Size of facility: \$200m | Interest rate: 3-month BBSY+1.50%

Prime Corporate Tower (PCT) will generate immediate returns and be fully operational from Day 1. Sterling Square (SS) will commence construction Day 1 and be fully operational from FY27 onwards. Assume the PCT facility is refinanced at the end of the 3-year tenor.

The interest rate on the loan facilities are above and calculated at the beginning of each quarter. Additionally, Prime Property Trust must maintain an Interest Coverage Ratio (ICR) greater than 1.75x at all times or risk breaching the terms of the loan and have its funding withdrawn. Prime Property Trust's cost base and projected revenue for the upcoming financial year is provided on the following page.

1.2.1 Cost Base and Projected Revenue

Prime Property Trust - Income Statement

All figures in 000's										
Item	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31	FY32	FY33
Rental Income										
Retail Rent	5,850	7,116	7,289	20,057	18,542	17,126	14,496	13,046	14,095	14,971
Office Rent	3,978	2,901	2,469	5,821	7,564	9,265	12,137	14,083	14,768	13,852
Total Rental Income	9,828	10,017	9,758	25,878	26,106	26,391	26,633	27,129	28,863	28,823
Less Vacancy Factor	-	-	-	-	-	-	-	-	-	-
Less Repairs & Maintenance	1,047	1,078	1,176	1,232	1,309	1,424	1,518	1,607	1,760	1,925
Less Management Fee	349	527	579	411	436	361	394	536	587	642
Less Outgoings Paid	-	-	-	-	-	-	-	-	-	-
Net Rentals (EBITDA)	8,432	8,412	8,003	24,235	24,361	24,606	24,721	24,986	26,516	26,256
Base Case										
BBSY (%)	3.70%	3.75%	3.49%	3.36%	3.40%	3.49%	3.59%	3.71%	3.82%	3.92%

(Source: Prime Property Trust Income Statement; Assume $ICR = EBITDA / \text{Interest Expense}$)

2 Rates Outlook

2.1 Equilibrium and Dynamic Relationships

2.2 Macroeconomics

3 Hedging Objectives

Maintenance of the debt covenants

4 Interest Rate Derivatives Valuation

4.1 Forward Rate Agreements (FRAs)

A Forward Rate Agreement (FRAs) is an over-the-counter (OTC) contract that locks in an interest rate for a future loan or deposit. The buyer of an FRA locks in the right to borrow at a specific rate, while the seller locks in the right to lend at that rate. The contract is settled with a single cash payment at the settlement date, based on the difference between the agreed-upon forward rate and the actual market interest rate (the "fixing rate") on a notional principal amount. No actual principal is exchanged.

4.2 BAB Futures

4.3 Interest Rate Swaps

4.4 Caplets and Floorlets

5 Hedging Deliberations

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6 Hedging Rationale