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Why insurance should be considered in the overall corporate strategic plan as a source of capital

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"Your warehouse is on fire!" Terrible words to hear late at night - or anytime, for that matter. Visions of flames licking at shelves of inventory, customers trading elsewhere, profits slipping away - and it's too late to buy the adequate coverage. Without warning, a portion of your invested capital can disappear in a matter of minutes. Both private and public companies require capital to operate and grow. In this article we will work to articulate why insurance should be considered in the overall corporate strategic plan as a source of capital.

Capital, in the most basic terms, is money. All businesses must have capital in order to purchase assets and maintain their operations. Most companies maintain their liquidity or capital through earnings and cash flow. Companies with predictable earnings will maintain their market valuation either through potential value in the marketplace if a private company or through increased stock value if they are a public company. Higher market valuation or stock prices are a form of currency the company can use to grow and expand.

"Capital is a necessary factor of production and, like any other factor, it has a cost," according to Eugene Brigham in his book Fundamentals of Financial Management. In the case of debt capital, the cost is the interest rate that the firm must pay in order to borrow funds. For equity capital, the cost is the returns that must be paid to investors in the form of dividends and capital gains. In the case of insurance capital it is the premiums paid for the limits of insurance purchased to protect against catastrophic losses.

Avoiding interruptions in earnings or reducing volatility in earnings has the potential of helping companies maintain a predicable source and cost of capital. "The optimal capital structure is the one that strikes a balance between risk and return and thereby maximizes the price of the stock and simultaneously minimizes the cost of capital." Companies that are able to maintain a strong balance sheet will generally be able to obtain funds under more reasonable terms than other companies during an economic downturn or catastrophic loss.

Companies can protect themselves against unexpected events that could have a negative impact on expected earnings. Companies can tighten their budgets and establish conservative cash reserves, or they can limit customer credit; lower borrowing costs; seek to obtain better credit terms from their vendors; cut expenses; institute safety programs throughout operations; outsource dangerous activities; or provide greater product safety testing. However, accidents still occur or a "black swan event" can happen. Large unanticipated negative financial events impact earnings. Companies cannot budget for large unanticipated events. What are their options?

Businesses can look to fund the event through additional debt capital. Another source of funding unexpected loss is equity capital. In many cases the most overlooked form of capital is insurance. If a company has the correct types of insurance, they can use it as a source of capital to the extent it applies to the loss, to the level of the policy limits. Insurance is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment. The transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate (indemnify) the insured in the case of a large, possibly devastating loss. Insurance can be a very effective hedge against volatility of expected earnings due to a catastrophic corporate loss.

Spencer Macalaster is the senior vice president at Risk Strategies Co., Boston, Mass.