

## **Correct type of insurance can be used 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. 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. There are many aspects of risk that real estate firms face today in the course of acquiring, selling, managing, developing or redeveloping property. Our team, in conjunction with real estate owners, identifies the risks and then designs, negotiates and implements insurance programs that can provide the capital to rebuilt, replace and continue operations. Real estate firms spend a significant amount of money to mitigate risk by crafting contractual language to address their concerns. This may address some of the exposure but not all. The use of insurance programs are designed and implemented to provide protection as a backstop to contractual language as well as providing coverage for those areas where contractual wording may not go far enough.

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 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 F. 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 predictable 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.

Risk Strategies has assembled a group of experts who are leaders in their respective disciplines of property, liability, construction, environmental, loss prevention and claim management. We have a unique approach of pulling together the right professional team specific to your real estate exposure, which is unparalleled in the industry.

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