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Insurance provides money to keep your company up and running after unanticipated events - by Spencer Macalaster

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“Your building 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 real estate companies require capital to operate and grow. There are many aspects of risk that real estate companies face today in the course of acquiring, selling, managing, developing or owning property. Risk managers along with their consultative brokers identify the risks and then design, negotiate and implement insurance programs that can provide the capital to rebuild, replace and continue operations. Companies can spend a significant amount of money to mitigate risk by crafting contractual language to transfer their exposure or install life safety systems to protect against catastrophic loss. This may address some of the exposure but not all. The use of insurance programs is designed to provide protection as a backstop to contractual language as well as providing coverage for other perils to loss.

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 predicable source and 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, they can tighten their budgets, establish conservative cash reserves, or limit customer credit; lower borrowing costs; seek to obtain better credit terms from their vendors; cut expenses; institute safety programs throughout operations; or outsource dangerous activities. 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 or raise 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 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.

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