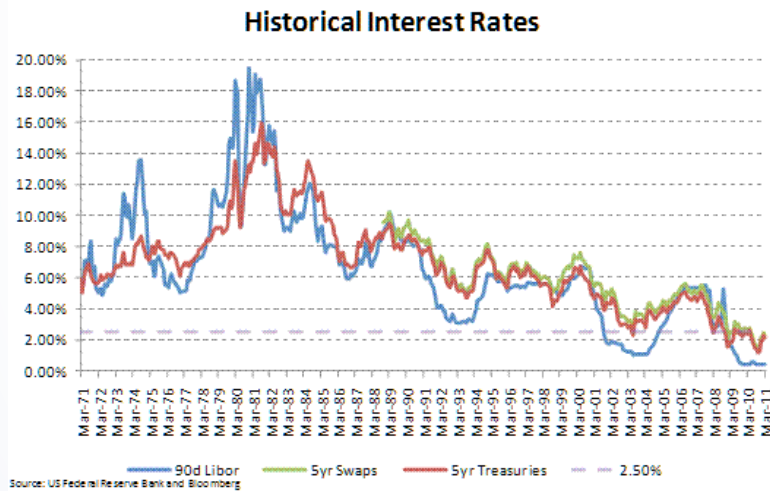


Fixed vs. Floating... What's the Right Answer???

I'll start with stating the obvious. This interest rate environment is unbelievable. Who would have thought rates could stay this low for this long? Right now, the lender's cost of five-year fixed rate debt is around 2.50% and floating rate debt is around 0.25% (a spread is added to get the all-in cost to the borrower). That translates to costing you, the borrower, 2.25% more on a fixed rate basis than a floating rate basis. You might wonder if the additional cost is worth it. To answer this question, think about the current economic environment and then ask yourself which way you think rates will go. You should also put this current interest rate environment in historical perspective and realize that we are living in a very unusual interest rate (and monetary policy) environment.

The chart below shows historical interest rates dating back 40 years to 1971. Since 1971, 90 day floating rates have been below 2.5% for less than a total of 6 years combined, with all of those occurring in the periods beginning in late 2001 to 2004 and 2009 to present.



So what's the right answer as to how much of your debt should be fixed and how much should be floating? When I first started out in banking in 1997, the rule of thumb was that if you had a lot of debt (regardless of what you thought rates were going to do), you would fix as much as possible so that you wouldn't lose sleep if interest rates started going up. While that is probably still good counsel for highly leveraged businesses, in this low rate environment I would go a step further and say that some of you with lower levels of debt may want to think about fixing more of your debt as well. Think about it: you can borrow for five years at rates below 5.0%. A lot of you may even be below 4.0% for five-year fixed rate debt.

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First Beverage Group is a full-service financial services firm dedicated exclusively to the beverage industry. First Beverage focuses on providing growth solutions to leading operators in all segments of the beverage industry through a comprehensive range of products, including private equity; merger and acquisition advisory; debt advisory; strategic and operational consulting; and real estate capital through sale-leasebacks and buy/build-to-suit transactions.

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I will refrain from making any predictions as to what rates will do over the next several years, but what I will do is tell you that if you fix a large amount of your debt and rates stay where they are now (they really can't go that much lower, can they?), you at least borrowed at a historically low rate. Think about the alternative, floating rates go back up over 5.0%, like they were a mere four years ago, and you unwittingly ride the curve right back up without fixing your debt...which would you prefer?

Therefore, if in the past a good target for the amount of fixed rate debt vs. floating rate debt was 50%/50%, I will go out on a limb and tell you that 70% to 80% fixed rate debt may make a lot of sense in this environment. Remember, you can fix your loan repayment schedule such that the percentage of fixed rate debt relative to floating stays consistent into the future. For example, you can still be at 70% fixed at the end of two years even if you have amortizing debt.

So how do you do it? Most of you have banks that offer interest rate swaps. I know some of you have lost money on them in the last few years. You may, however, have taken a less than optimal step for your financial planning. Don't let the product (or your history with it) scare you. **An interest rate swap is almost always better than a pure fixed rate from a bank.** First, it is usually a portable product, meaning that if you refinance your debt with another bank, they can usually take an assignment of the existing swap (keeping you from having to give up a great rate or pay breakage costs). Conversely, fixed rate notes are not assignable to other banks.

Second, unlike a fixed rate loan, a swap can actually create value. If you prepay an interest rate swap and rates have gone up, you actually get the proceeds from breaking the contract (that is referred to as being "in the money"). Conversely, you typically do not participate in the upside with a fixed rate note. If interest rates go down and you prepay the debt, you will be charged a breakage fee in both the swap and the fixed rate circumstance.

One last point...if you have no debt and you pay for capital expenditures with cash flow, you are essentially reinvesting your equity back into your business. You may want to think about putting some debt on the books to cover those expenditures. You will most likely be able to borrow at rates below 4% (and possibly as low as 1.5% on a floating rate basis). If you can redeploy that equity elsewhere, you win if you can beat that low cost, but you also win because you will have hopefully diversified your equity.

There you have it. If you have any questions about your debt, give me a shout. I'd love to talk to you about it.

- SEAN MCLAREN

