Swaps as a Cash Management Tool

This case study details how fixed-for-fixed interest rate swaps may be employed as a cash management tool for a firm with a seasonal component to its cash flows. Such an approach to cash management may be more cost effective than traditional borrow/lend techniques. In keeping with the global dimension of the swaps markets and their uses, we have avoided making the case currency specific.

IV: An Application: The Case of World Tours, Inc.\(^4\)

Consider the following situation. World Tours, Incorporated (WTI), a travel agent that books overseas, primarily European, tours, aggressively markets its product. Company policy requires that tours be booked and paid for at least 90 days prior to departure. Tour payments are nonrefundable after the payment due date unless a cancellation is dictated by a demonstrable medical condition. Revenue is recorded, for reporting purposes, on the tour departure date. The firm receives 15 percent of tour revenue for its booking services. The remainder is paid to the tour organizers. The firm has a fixed overhead of 160,000 domestic currency units (DCU) per calendar quarter. Its variable costs amount to 7 percent of tour revenue. Of this, 4 percent represents commissions to its salespeople and 2 percent represents advertising expenditures. The remaining 1 percent covers miscellaneous variable costs.

\(^4\)This application stems from a specific consulting case. The name of the firm, which is intended to be fictitious, and the context of the case have been changed to protect proprietary materials provided by the client.

The firm's quarterly revenue can be converted to before-tax profit as follows:

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\text{Before Tax Profit} = [(15\% - 7\%) \times \text{Revenue}] - 160,000 \text{ DCU}
\]

WTI's bookings and profits have been growing over time. However, profit is highly variable from quarter to quarter. The historic quarterly revenue and profit for the 24 calendar quarters from the first quarter of 1985 to the last quarter of 1990 are reported in Exhibit 15.4. Historic profit is also depicted graphically in Exhibit 15.5.

Until early 1991, WTI was entirely equity financed and had no outstanding debt. In late...