Hedging foreign currency and interest rate risks with Derivatives: How much does it increase the firm's value?

ABSTRACT

Traditional finance theory suggests that a company can't increase its value by changing the riskiness. However, recent studies show that it is possible to increase the firm's value using hedging instruments. In my research I pretend to show that hedging with derivatives increases firm's value, as already have been demonstrated in several different markets. The sample includes the 336 non-financial firms quoted in Lisbon, Madrid and Milan stock markets at the end of 2006.

This study presents empirical evidence on the valuation effects of Foreign Currency (FC) and Interest Rate (IR) hedging with derivatives, measured by Tobin's Q. Depending on the Tobin's Q definition, I found a 4.48%, 8.92% or 11.88% significant premium for derivative hedging firms. I also found that 91.1% hedging firms are derivative users. Sample was separate in Iberian Market (Lisbon and Madrid stock markets) and Italian (Milan stock market) subsamples. Statistical and regression methods evidence that to the Iberian firms hedging activity has more impact on firm's value than to Italian ones. Results evidence important statistical significant premiums for foreign currency and interest rate derivative hedgers in Iberian Market, about 6.37% to 20.75%, whereas Italian Market displayed significant value only with interest rate derivative hedging firms.

Keywords: Firm's value; Corporate hedging; Derivatives; Foreign currency hedging; Interest rate hedging.

JEL Classification: F30; G32