State the obvious

Recent candidates lost out by not citing relevant facts that they probably knew. Doug Williamson explains how to pick up easy marks

Have you ever wondered what your examiner's biggest concern is? This excerpt from the MCT Examiner's Report, October 2011, should help to explain:

"Overall, my biggest concern is the lack of understanding of corporate finance principles and concepts. Candidates have some formulae, some facts and some practical knowledge, but no reliable conceptual framework and a seeming reluctance or inability to rehearse the fundamental theories of corporate finance."

In this article, we recap selected corporate finance theory and other mark-earning knowledge and then apply it to a recent exam case. The article also suggests useful boilerplate (generic) wording – for you to reuse appropriately elsewhere.

When should I state the obvious?

The answer to that is: "Almost always." If you know something, but don't say it, your marker isn't allowed to give you any credit for it. But say it concisely.

Easy marks are almost always available for making relevant general frameworking points (as well as for your application points). You need to practise writing the 'eternal truths' concisely during your revision, so you can reproduce them quickly in your exam. This gives you a structure and time in hand to move on to your application points.

From your marker's point of view, there is sadly no difference between a candidate who simply doesn't know (being 'unable' to write it down) and you when you do know your stuff, but are 'seemingly reluctant' to write it down. So raise yourself into the elite group of candidates who both know their stuff and write it down. Pick up those easy marks.

Example question

MCT Case Study extracts Q4(a) October 2011

What are the arguments, both theoretical and practical, for and against the company targeting, say, a BBB rating, rather than a higher or a lower one...? (6 marks)

The case study company (NVS) operates in a stable market sector and it currently has a BBB- credit rating. The company's primary objectives in capital risk management are to:
(1) Safeguard the business as a going concern;
(2) Maintain sufficient financial flexibility to undertake investment plans;
(3) Retain as a minimum an investment grade credit rating; and
(4) Optimise capital structure in order to reduce the cost of capital.

NVS is profitable and tax-paying, its latest accounts showing an effective tax rate of 20%.

GENERAL TRUTHS ABOUT Q4(a):

Relevant eternal truths

An eternal truth is a generally true and useful statement. Investing in learning, it will repay you handsomely.

Relevant general truths, simply stated, about Q4(a) above, include:
(1) BBB- is the lowest investment grade credit rating.
(2) Minimising weighted average cost of capital (WACC) will theoretically maximise value for shareholders (SHV). WACC is minimised by using some debt, but not too much.
(3) Here, as elsewhere, flexibility and cost trade off.
(4) More debt means a lower credit rating, higher interest costs and other costs, less operating and financial flexibility, and greater financial risk for the borrower.
(5) More debt normally saves more corporation tax for the borrower. Because interest and other debt-servicing costs are normally tax-allowable expenses (while equity dividends are not).
(6) Higher rates of corporation tax make the potential tax savings ('tax shields') more valuable.

Having recapped our eternal truths, let's review:
(i) what the examiner wanted for Q4(a); and
(ii) what candidates produced.

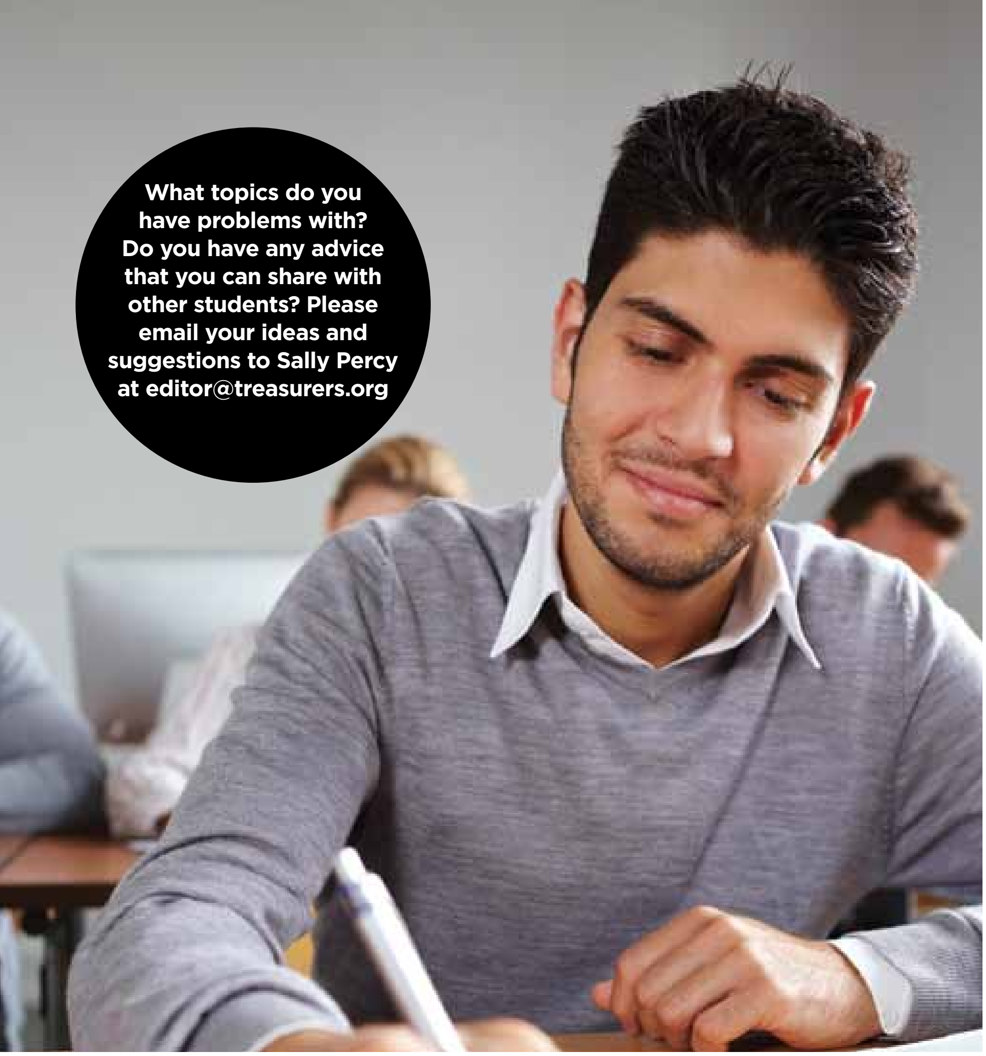
What the examiner wanted

"I expected an exposition of the classical optimal capital structure arguments to be followed by a discussion about re-calibration/re-evaluation of the optimal capital structure following the impact of the credit crunch, but I didn't get it from anyone."

What the candidates produced

"All I got was the classic treasurers' argument about a higher credit rating reducing the cost of debt (often referred to loosely as 'cost of funds'). No one fully articulated the Modigliani & Miller arguments for or against different levels of gearing and the impact on WACC...

"The shareholder perspective hardly received a mention, for example, minimum WACC, maximising shareholder value...



What topics do you have problems with? Do you have any advice that you can share with other students? Please email your ideas and suggestions to Sally Percy at editor@treasurers.org

You need to practise writing the 'eternal truths' during your revision, so you can reproduce them quickly in your exam. This gives you a structure and time in hand to move on to your application points

"No one discussed the subtle difference between fewer, tighter financial requirements (low gearing, high interest cover) that come with higher investment grades and the more restrictive non-financial covenants combined with looser financial requirements and covenants that come with lower ratings. Very disappointing!"
MCT Examiner's Report, October 2011

Structure to answer Q4(a)

There are seven key parts in Q4(a). We need to respond to each of them explicitly. Look at the seven highlighted words in the question: "What are the arguments, both theoretical and practical, for and against the company targeting, say, a BBB rating, rather than a higher or a lower one...? Good answers will respond to – and preferably echo – all seven of these key words.

You can structure your response in any way you choose. The purpose of any chosen structure is to: a) help you to make lots of good points quickly; b) hit every sub-part in the question; and c) stop worrying.

The response below is a short-form narrative with highlights. Alternatively, we could have used a table.

A good answer to Q4(a)

The main driver of NVS's credit rating is the relative amount of its debt capital. This is quantified by balance sheet gearing/leverage, interest cover and income leverage. The more debt NVS uses, the lower/weaker its likely credit rating.

In theory, NVS should target the level of debt that minimises its WACC and so maximises its SHV. This is NVS's fourth capital risk management objective. This may be close to the current debt level and rating of BBB, the lowest investment grade rating.

But, more commonly, the WACC-minimising level of debt would be higher (and the related credit rating correspondingly lower).

The reason for this is that additional debt finance creates additional tax shields, sheltering otherwise taxable profits from corporate tax.

Theoretically, WACC only starts to rise again when incremental financial distress costs start to exceed incremental tax shield benefits.

NVS is tax-paying (effective tax rate 20% in 2011), so the related tax shields are valuable. If the tax rate were higher, the tax shields would be even more valuable. So optimal debt levels would then be greater, and the optimal credit rating lower, almost certainly lower than BBB.

In practice, many firms target a lower level of debt and a higher credit rating – for example, higher than BBB – to enjoy the following advantages:

- More safety margin against routine downturns. And (post-credit crunch) against more severe financial shocks. (Safeguarding the business as a going concern in this way should arguably always be the overriding objective.)
- More independence and control of the business.
- Freedom from restrictive non-financial covenants.
- Less vulnerability to acquisition.
- More flexibility to raise additional funds for future growth.

Disadvantages of BBB or higher rating:

- WACC higher than optimal, so SHV not maximised.
- Tight financial requirements – low gearing and high interest cover.

Disadvantages of a lower than BBB rating are, of course, the opposite of the advantages of a higher rating noted above, including:

- The burden of restrictive non-financial covenants.
- Balanced by the potential flexibility of looser financial requirements.

Arguably, it is unnecessarily constraining to target any particular level of rating in an uncertain environment.

Investigate and understand what NVS's peer group is doing, and why.

Finally, make your own points

Here, as elsewhere, exam marks are awarded for the number and the quality of the points you make. You don't need to make all of the points noted in the example answer above. Write what you can in the available time and move on. And your alternative/additional valid points will, of course, be fully credited.

With all best wishes for your studies.

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