risk management

CASE STUDY

Setting a framework

Executive summary

- Bertelsmann's risk management strategy is based on three principles: alignment with the general strategy of the organisation, a clear understanding of who is responsible for what, and reporting procedures that can cope with the autonomy of the business units.

Bertelsmann is a large media group, mainly operating in Germany, France, England, Spain and the US. In 2007, it reported annual revenues of €18,578m and EBITDA (earnings before interest, taxes, depreciation and amortisation) of €2,467m. The treasury team sits within Bertelsmann's corporate treasury and finance operation, alongside corporate finance, international finance and insurance. The organisation has a system of treasury review that assesses treasury reports and is responsible for the risk assessment of treasury issues, such as the calculation of value of risk and interest rates. The treasury team reports directly to the head of treasury and finance. The treasury also has a separate back office that deals with daily administration issues.

FRAMEWORK The company operates within a risk management framework and has guidelines which are binding for the executive board, management and the divisions worldwide. In his presentation to the ***talkingtreasury*** conference in Dusseldorf in September, Stephan Scheller, the company's senior vice president for treasury, explained that the framework ensures the group's approach to risk is planned, put into practice and reported according to consistent principles. The risk management framework helps uphold the autonomy of the corporate divisions, an important issue for Bertelsmann. As a general principle, the responsibility for the operating businesses lies with the executives of those units. The group has guidelines which, among other things, cover:

- corporate finance;
- investment practice (including divestments and the content of an investment proposal);
- rental and leasing agreements;
- derivative transactions;
- contingent liabilities in favour of third parties; and
- corporate insurance.

Scheller stressed that the guidelines were just that and were not detailed, although each one runs to around four or five pages and sets out the general framework.

Scheller explained the company's financial targets, laid out in the finance guidelines. He said the overall idea is to ensure a balance between financial security, return on equity and growth. The company's financing is oriented towards the requirements of a BBB+/BAA1 rating (see Table 1), the overall financing target of the group. The leverage covers all external debt (including bonds, loans and notes), net pension liabilities (Bertelsmann has now set up a contractual trust arrangement) and the finance and operating leases.

Beneath the finance guideline sits the financial policy, which is the Bible for the company's corporate treasury and finance. Used as a supplement to the executive board guidelines, the policy outlines the basic work of corporate treasury and finance, providing detailed procedures. The financial policy is driven by two principles:

- concentration of cash and financing of Bertelsmann to avoid structural subordination; and
- the desire to provide independent analysis from an economic perspective free from bias as a result of, for instance, specific accounting treatments.

The financial policy covers, among others, the following areas:

- banking policy, including core bank principles;
- financing of subsidiaries (including debt-equity mix and dividend policy);
- cautious use of off-balance sheet financing, partly to ensure no distortion of the return on investment/asset calculation;
- cash management and investment principles; and
- rules governing interest rate and foreign exchange risk.

FOREIGN EXCHANGE Scheller explained that Bertelsmann, despite its size, focuses on many local markets, as each media business has

AT *TALKINGTREASURY*, BERTELSMANN'S SENIOR VICE PRESIDENT OF TREASURY FOCUSED ON HIS GROUP'S RISK MANAGEMENT STANCE. **PETER WILLIAMS** REPORTS.

to recognise local cultures and local languages. As a result, it does not have a lot of cross-border transactions. However, Scheller said that with Bertelsmann's service company performing an increasing amount of business on an international basis the treasury department recognises an increasing demand for transaction risk hedging. The service company's customers include global players such as Microsoft and Google both of which operate internationally and this is leading to increased transaction risk for Bertelsmann at a subsidiary level.

The company also has a procedure in place which ensures that intercompany loans are 100% hedged.

The other element of transaction risk arises from individual projects. Bertelsmann does not hedge economic risk because it is difficult to isolate the risks and not always possible to determine the correlation. The company differentiates between direct and indirect currency risks. The transaction risk is the effect of changes in exchange rates on future cashflows in foreign currency which are manifest in sales in foreign currency, intercompany loans and projects, while the translation risk (the effect of changes in exchange rates on balance sheet and profit and loss) is apparent on the consolidation of subsidiaries.

The company's principal currencies are euro, US dollar and sterling. Scheller said that in terms of managing currency translation risk the leverage factor at group level "is a bottleneck on financial flexibility". The leverage in currency areas may differ from the group leverage factor with the consolidated debt in euros depending on the exchange rates at the year-end. The type of volatility recently experienced in foreign exchange markets could well have a negative impact on group leverage.

The treasury has two currency translation objectives. First, to avoid short-term negative impacts on the leverage factor from changes in the exchange rates, and second, achieving an adequate leverage factor in all currency areas in the long term. To meet its objectives, the company takes direct measures such as dividend payments to increase the leverage in one particular area, and indirect measures such as using derivatives for hedging or unhedged intercompany loans.

Table 1: Financial targets

	Target	Actual 2007	Actual 2006
Leverage factor	<3.0x	3.1x	3.4x
Interest coverage ratio	>4x	5.0x	6.2x
Equity ratio	>25%	28%	29%

Scheller says that before taking any action the treasury tries to look at all other factors such as the tax and the deductibility of interest.

DEALING WITH DERIVATIVES The Bertelsmann guidelines cover the decision authority, execution, procedures and reporting for the corporate use of derivatives. Executives in the operating unit exercise autonomy, so the responsibility for the operating risks rests with the executive at the profit centre/business unit level.

However, as might be expected, the management of the financial risk rests with the corporate finance and treasury department. Permitted counterparties are in place depending on the credit risk involved in the derivative and authorisation for the relevant employees. A quarterly reporting system is in place, so the profit centres have to ensure that they report currency and derivatives exposure to the corporate finance and treasury department in that timescale.

The quarterly reporting of on and off-balance sheet foreign exchange (FX) exposures involves the collection of data from more than 1,000 reporting units via a web-based reporting system. Scheller said that in terms of trading volume in 2007 the company made 2,596 external deals, of which 437 were money market deals amounting to €22.823m, 828 FX spot/forward transactions amounting to €708m, and 1,331 FX swaps amounting to €5,985m. Internal deals included 489 FX spot/forward transactions amounting to €427m and 344 FX swaps amounting to €803m.

Scheller stressed that proper reporting was essential given the independence of the operating units. "This reporting is necessary to keep us [treasury] informed of the overall risk position, and it helps us to manage currency risk at a group level. It also enables us to fulfil the external requirement of reporting under IFRS 7."

Most of the company's debt is financed over the long term from the capital markets. The company has small maturities due in 2009 and 2010. With the financing in place, the need to replace maturing debt is limited, said Scheller. The company's management of interest rate risk is totally separate from its financing. It is based on the group's net financial debt and the expected movement in interest rates. The treasury aims to reduce the volatility in interest expense. The tools adopted by Bertelsmann to achieve these objectives include a quarterly report of agreed interest periods and the calculation of duration brackets and sensitivities by currency. Also, treasury compares existing positions with expected interest rate developments and proposes tactical measures for discussion with the head of corporate finance or the chief financial officer, depending on the size of the debt in question.

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