4.2.3 Risk Identification and Assessment Exercise Answer

Unit:	Unit 1 – Treasury Strategy
Module:	Module 4 – Financial risk
Date:	1 September 2016
Summary:	Answers to exercise in identifying and assessing risk.

Answer 1
Identify five major finance/treasury risks facing LT in the medium term, with a brief one-line justification for each risk identified.

- fuel, given price volatility and significance for travel cost (own aircraft and third party).
- FX (transaction), again given potential volatility and proportion of costs exposed to FX risk, e.g. for accommodation, catering.
- liquidity, given size of seasonal swings in cashflow
- interest risk on debt and depos.
- counterparty risk on cash balances and mtm on derivatives, the latter a two-way item
- Others: pension, FX translation

Although this case study was based on an old exam paper, we can of course add Brexit to the risk, although most risks are reflected in the above list. Changes in tax (e.g. withholding taxes), tariffs spring to mind, but these will probably pale into insignificance compared to operating issues such as air operating regulations, although it is hard to see European countries sacrificing revenue from tourism.

Answer 2
LT is exposed to several typical treasury risks including

- fuel price risk
- currency pre-transaction risk

For each risk:

a) Explain how the risk arises in LT.
Fuel: significant and volatile element of travel costs.

FX pre-transaction: significant, volatile element of non-travel costs; to issue catalogue prices and not have to resort to last minute surcharges, LT needs to hedge these costs well ahead of the season.

b) How material is each type of risk for LT? Quantify and indicate the level of sensitivity, noting any assumptions made.

Fuel: Comprises around 8% of total costs, with a recent history of increasing by as much as 50%. So very significant in this low margin business. Note that the hedging of this risk gives rise to another, i.e. the potential cost of collateral calls on derivative mtm valuations.

FX: Overall, after hedging, LT 2009 accounts state that a 5% shift in EUR and USD would impact PBT by £18.8m.

In the Case section 3.5 TCAG labelled this risk Portfolio "Tour Operator". MT discussed it in terms of the budget cycle and the pre-season booking period. Section 2.0 Tour Operating Sector indicates tour operator margins of 5-10%. Taking the cost breakdown of tour operators on pages ¾, and making assumptions about non -domestic parties:

Accommodation	34% x 0.75	= 25%
Aviation	38% x 0.50	= 19%
Destinations	8% x 1.00	= 8%
		52%

So at least 50% of costs are exposed to FX volatility and margins are as low as 10% of that number, so even minor volatility can be terminal!

As for fuel, collateral calls are a potential problem.

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