# 3.3.3 Financial Strategy

# Self-Test Questions

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| **Unit:** | Unit 1 – Treasury Strategy |
| **Module:** | Module 3 – Financial strategy |
| **Date:** | 1 September 2016 |
| **Summary:** | Questions around aspects of financial strategy |
| **Keywords:** | leverage, liquidity, credit rating, target, spread, margin, life cycle, investment grade, high grade, sub-investment grade, junk, high yield, structured finance, dividend, interest rate risk, translation risk, foreign exchange risk, target, degrees of freedom, options, flexibility |

Provide brief answers to the following self-test questions:

**Question 1**
Choosing to make debt part of the financial structure requires investors willing to lend debt. To what extent are the decisions around leverage and liquidity interrelated?

**Question 2**
Why is a credit rating target often a key element of a financial strategy? What are the implications of this?

**Question 3**
What banking choices are available for a mid-sized engineering company with operations in Europe, the US and Asia? What approach to the relationship issue is likely for this company?

**Question 4**
Why are dividends said to carry signalling information?

**Question 5**
Why might a company buy back some of its ordinary shares?

**Question 6**
Your company, Bandit SA, holds a minority stake of 10% in one of its American suppliers, Fazer Inc. Fazer Inc is an important supplier to Bandit, and Bandit holds the stake mainly so that it can influence decisions made by Fazer, and to ensure (as far as possible) that Fazer's supplies to Bandit meet Bandit's strategic business needs. The balance of Fazer's shares are quoted on the NYSE.

Fazer is planning to undertake a large rights issue to increase its equity base to fund an aggressive acquisitions programme being promoted by its chief executive.

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One of your non-executives is fearful that 'this rights issue will dilute Bandit's interests. Briefly describe why this might be; it may help to illustrate with simple numbers. What alternative approaches might Bandit suggest to Fazer in order to preserve its influence?

**Question 7**
Why is the potential for profit growth particularly important for private equity investors in leveraged buy-outs / management buy-outs?

**Question 8**
Automation Inc is a producer of traffic management systems and has a major market on the Iberian peninsula supplying city traffic control systems, including computer assisted traffic lights with CCTV support. It is a requirement of the Spanish authorities that installations are carried out by a local contractor with a stake in the contract. Strict interpretation of this corporate arrangement reveals that contracts are deemed to be joint ventures, investment in which by Automation Inc is strictly limited under the terms of its high yield type bank financing. This is because joint ventures are deemed unsuitable for weakly creditworthy companies because they absorb cash on the investment and are relatively illiquid as a 'gone concern' credit protection measure. How can Automation Inc deal with this issue?

**Question 9**
Simplicity plc, a sub investment grade borrower with significant bank debt, has a subsidiary in Japan (Power City KK), of which it owns 58% of the common stock, thus including it as a subsidiary and group member for the purposes of the loan agreement. Power City KK is, because of the minority, effectively independently controlled and has its own financial strategy. It borrows heavily. Simplicity is concerned that a default on the borrowings of Power City will cross default into group borrowings. How should Simplicity deal with this issue?

**Question 10**
Describe briefly 4 considerations in funding subsidiaries.

# Answers

**Answer 1**
The two issues are heavily related. A decision on the level of leverage must take into account the liquidity of markets in being able to fund that debt. However, it is probably the leverage decision that comes first in that leverage is only really possible in firms that can take on the financial risk, in which case the lending markets can usually accommodate that leverage. Leverage defines a company and its business model and its target return on equity. Typically, many different markets are tapped to achieve the desired leverage.

However, sometimes liquidity drives the capital structure, especially in structured deals. Some lending markets will lend up to certain multiples of e.g. EBITDA, depending on economics and fashion. Here, liquidity comes first as the deal is structured around those limits.

Thus at extremes, liquidity is probably more important than the actual leverage decision.

**Answer 2**
A credit rating target is usually adopted to ensure liquidity in financing and to make routine refinancing occur without dramas. An investment grade rating can ensure access to liquid bond markets. However, a strong rating also carries reputational virtues and so, long-term contracting firms may target a strong rating to ensure that its customers cannot question its commitment and cannot use a weak rating as an excuse to take their custom elsewhere. In structured finance, e.g. some High Yield arrangements, a rating may be targeted at say single B, rather than CCC to identify a particular point in the market with sufficient capacity to lend.

The implications of targeting a rating are that certain financial ratios are targeted, such as net debt / EBITDA, interest cover and so on. Understanding the rating agency or bank model is also then an implication.

**Answer 3**
They are broadly

- Transactional v Relationship
- Domestic v Foreign
- Large v Small
- Commercial v Investment

The dimensions apply in several different areas:

- Cash management
- Lending
- Equity finance
- Bond finance
- Mergers & Acquisitions
- General advice
- Trade finance
- Supply chain finance

It is quite possible for the company to take a different view for each particular sector. In cash management it might decide to have a domestic bank in each Asian country but to have a foreign bank in Europe to manage the highly centralised cash management structures possible there.

As a mid-sized company, the usual approach is to go for relationship banking and it is likely that this firm has four to five major bank relationships that will execute almost all its business, with the possible exception of some local banking in Asia.

**Answer 4**

Dividends are one of the few methods by which management can convey information to investors. This might seem strange when so many communication channels are available, but dividends are an emotive part of the story. This is primarily because they are a physical transaction and require cash.

An increase in dividend is normally seen as management showing confidence in their prospects, although it could be that it is introducing a way of returning cash for which no other investment purpose can be found. A reduction in dividend is definitely seen as a loss of confidence in prospects.

Management will compare their payout policy with their peer group and this gives both management and investors another context to view the signalling aspect of dividends.

**Answer 5**

There are various reasons for share buybacks:

- The company might have a large cash surplus for which it has no foreseeable requirement. A share buyback would be an alternative to a cash dividend as a means of giving cash back to shareholders, and might be preferable to a higher dividend.
- A share buyback programme can be used to support the share price (by decreasing the number of shares available in the market), and / or to manage the number of shares in issue. However, in theoretical corporate finance terms this is merely a device with no economic impact on the company.
- A share buyback often acts as a signal of confidence in the future, with management informing investors that they do not require all the cash the firm has earned, because they expect the company to remain cash-generative in the future or because they think the market has undervalued their shares.
- Buying back and cancelling a large block of shares might be used as a tactic to reduce the threat of a hostile takeover bid for the company, particularly if the remaining shares are retained by long-term investors in the company.
- Sometimes a reduction of equity capital and an increase in debt is desirable to increase shareholder returns.

**Answer 6**

Fazer is a US company, where there is no right of pre-emption. Fazer is thus free to offer its rights issue to anyone it chooses, rather than first to existing shareholders, and if the rights issue is large enough, then Bandit's shareholding will be diluted significantly. For instance, if Fazer had 100 million shares in issue prior to the rights issue and issued a further 100 million by way of rights, Bandit's shareholding (and hence influence) would fall from 10 million out of 100 million, to 10 million out of 200 million; i.e. from 10% to 5%. Bandit's voting power (i.e. influence) over Fazer would also fall proportionally, and this might have serious commercial consequences. In addition to the loss of voting power, and depending on the price at which Fazer's rights issue was launched.

Using its current influence, Bandit could ask Fazer to offer it new shares in proportion to its current holding. As an alternative, it could ask Fazer to structure the rights issue as a placing with clawback; Bandit could then buy back as many shares as it wanted to meet its strategic objectives.

(Note that Fazer may be undertaking the rights issue precisely to dilute certain shareholders e.g. Bandit, for instance if Fazer believes that Bandit is hindering Fazer's strategic development. Bandit, as a minority shareholder, would have to recruit a majority of other shareholders to vote against Fazer's proposals if it wanted to make Fazer change its plans.)

**Answer 7**

Growth in the Enterprise Value (EV), for a future sale or listing, is the main source of the Private Equity investors' return as there is usually little or no cash dividend. Moreover, on day 1, the EV comprises mainly debt with a thin layer of equity (recall EV = $MV_d$ + $MV_e$). If the venture performs as predicted, any increase in EV goes 100% to the equity holders who will see a significant return on their investment.

**Answer 8**

Automation Inc. should 'carve out' joint ventures relating to traffic installations in Spain from the prohibition in the loan agreement. Other joint ventures would still be prohibited.

**Answer 9**

A "basket" can be created so that a default on the borrowing of Power City KK would be less than the basket amount. Thus if Power City KK borrows £10 million (equivalent), the basket can be set at £20 million so that a local default does not potentially bring down the group. Power City KK could also be 'carved out' of the cross default.

**Answer 10**

Any 4 from the following:

**Key Considerations:**

***Ownership***

100% equity ownership gives the parent total control, but also leaves it with 100% of the equity risk in the group company. 100% ownership also implies moral and legal obligations by the parent to manage the subsidiary properly. If the parent holds less than 100% then the parent will generally have to negotiate with the other shareholders each time it wants to take action. In many countries either a local shareholder is required by law, or even if not, it is a political necessity.

***Equity versus Debt***

In an ideal world, shareholders will wish to minimise their stake, and hence their risk, leaving the group company with little equity and substantial local borrowings. Real world factors that lead to increased amounts of equity in group companies include:

- Gearing considerations. If funding externally and on a non recourse basis, lenders will only be willing to lend up to a certain point. The balance of funding has then to be sourced from equity.
- Tax effects. Tax authorities commonly have rules ('thin capitalisation rules') which impose a minimum proportion of equity and maximum debt level for companies.

***Parental support***

So long as the parent has a legal or moral obligation to prevent the subsidiary from defaulting, the subsidiary actually has no real independent capital structure except in relation to tax authorities and other creditors. When parent company or cross or upstream and downstream guarantees are given to subsidiaries' bank creditors, the benefits gained by using high local debt levels tend to evaporate.

Parents may prefer to issue letters of comfort, which evidence the moral obligation to support the subsidiary, without accepting a legal obligation to do so. However, it can be argued that the parent that walks away from its insolvent subsidiary is likely to have problems with all lenders thereafter.

**Other major considerations:**

***Central or local borrowing***

A subsidiary's borrowings may either be sourced locally, or to be sourced centrally and lent to the subsidiary by intercompany loan. Local borrowing may be useful to underpin local banking services such as cash management, trade finance or foreign exchange facilities. However, it can be more expensive than intercompany lending. Interest on cross border borrowing (e.g. an intercompany loan) may attract withholding tax, which is a tax levied by the remitting country's tax authorities on the income of the recipient.

***Cash management:***

Remittances to and from the parent. There are five core forms of remittance, and all non-trading flows (i.e. flows that are not settling intercompany trading transactions) must take one of these forms.

- Equity injection
- Loan
- Dividends
- Royalties
- Fees & charges

***Systems***

Cash management systems are important if cash is important to the group. Subsidiaries need to be both funded and defunded in order to safeguard the cash centrally, and use it elsewhere as needed. Cash management systems are important to ensure that cash can be moved efficiently and quickly around the group.

***Tax considerations:***

- Withholding taxes
- Double taxation treaties
- Need for an SPV for financing purposes
- Treatment of dividends in intermediate holding companies
- Ability to take advantage of tax havens
- Efficient routing of funds flows
- Need for an SPV for disposal purposes