Case Study 1

1.4.1 Teleware Inc Background Information

Study Unit: Study Unit 3 – Strategic Treasury Solutions

Case: Case Study 1 – Treasury opportunities

Date: 1 September 2016

Summary: Background information on Teleware, the acquisition target for Victor Plc in Study Unit 3. Includes a wide range of data on the company's group structure and a significant amount of information on the company's indebtedness which is of great relevance to the Case Study. The acquisitions calculations include valuations performed by the corporate finance department based on forecast cashflows.

Key words: capital structure, debt, bond, enterprise value, refinancing

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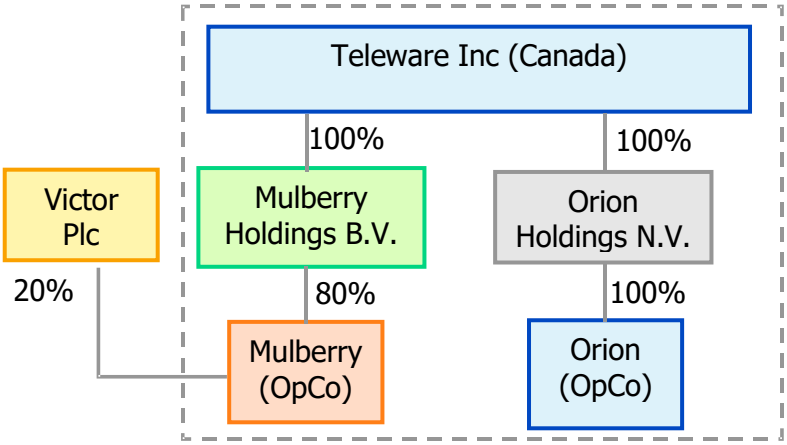
1 Background

On 31 December 2016, Victor Plc ("Victor") was presented with the opportunity to acquire Teleware, a listed Canadian company, for US$17 per share. Teleware controls two major assets: Orion, a fixed line operator in the Czech Republic, and Mulberry, a Romanian fixed line operator.

Exhibit 1: Teleware group structure



The acquisition is being managed by a project team, which includes representatives of a number of departments including Treasury.

Over the past year the Teleware share price has ranged between US$8.3 per share and US$ 15.6 per share. The closing price on 31 December 2016 was US$14.4 implying a market capitalization of $3.1 bn.

From a tax structuring perspective it is likely that Victor International Holdings B.V, ("**VIHBV**") one of Victor Plc's Dutch Holding Companies, would be the most suitable entity to acquire Teleware Inc. It is intended that VIHBV will borrow the consideration proceeds from Victor Plc. Victor Plc has available cash reserves well in excess of the purchase price and available to be spent in Europe. However, it might be necessary to utilise the capital markets to achieve a suitable balance between cash and debt to be ready for future opportunities. For the purposes of this analysis it is assumed that cash reserves can be depleted only to the extent of USD 2,200 million.

Victor already owns a 20% stake in Mulberry, the joint market leader of a duopolistic market. However, the prospect of gaining control is attractive and in line with Victor's stated strategy of "increasing stakes in existing affiliates as long as the investment adds shareholder value". Teleware adds fixed line capability as well, also in line with the strategy of increasing the unified offering to customers. The fact that Victor has an existing stake in Mulberry means that it has access to Mulberry's long range plans as well as a good insight into the way Mulberry is run. Thus, from an operational perspective the Mulberry leg of the acquisition is less risky than the Orion leg, Orion being an unknown entity to Victor.

Romania has a low fixed line penetration of less than 25% and thus represents high growth potential, with a population of around 20 million and a GDP per capita of around $6,200. Additionally, Romania has seen a reduction in its corporate tax rate from 25% to 16%. Furthermore, it looks as though Romania's historic economic instability might be behind it, following its entry to the EU in January 2007. Romania's core inflation rate over the next twelve months is expected to be around flat compared to a Euro region average of almost flat to very slight deflation. Against this positive backdrop, there is the possibility of added competition from a third operator looking to enter the market.

The opportunity to extend Victor's global footprint into the Czech Republic is complementary to its other Eastern European stakes in Albania, Hungary and Poland. Orion, despite being the third operator in a three operator market, is the fastest growing operator with a year-on-year revenue and EBITDA (earnings before interest, tax, depreciation and amortization) growth of 31% and 45% respectively.

The Czech Republic market is close to 100% mobile penetration, with 10 million subscribers out of a population of 10.5 million but low fixed line penetration, with around 1 million users. GDP per capita is quite high at about USD 15,000.

On 1 January 2017 the proposal to acquire Teleware was presented to the Victor board.

2 Ownership structure and indebtedness

Teleware owns 80% of Mulberry through a 100% ownership of Mulberry Holdings B.V. ("**MHBV**"), a Dutch Holding Company (see Exhibit 1). At the MHBV level there is public bond debt, $225m 12.5% senior bonds due 31 July 2020. At the Mulberry (OpCo) level there are bank loans fully drawn under a US$ 300m bank facility. The bank loans are similarly a senior obligation, with interest payable quarterly in arrears at a rate of 3 month USD ICE London Interbank Offered Rate ("**ICE Libor**") plus 3%, starting 1 January 2014. The bank loans are non-amortising, but fully repayable on 1 January 2018.

Despite being a Romanian company Mulberry's functional currency is US Dollars and not Romanian Leu, reflecting the historic high inflation and currency devaluations which have characterized the Romanian economy in the past. Such economic instability has been the driver behind Mulberry's policy to effectively[1] invoice its customers in US dollars. MHBV's functional currency is likewise US Dollars.

Teleware owns 100% of Orion Holdings N.V. ("**OHNV**"), a Dutch Holding Company, which in turn owns 100% of Orion, the operating company. At the Orion level there is both public bond debt, €325m 7.5% due 15 October 2021, as well as Euro equivalent 125 million senior bank loans drawn under a Czech Koruna ("**CZK**") bank facility (equivalent to €225million in total), attracting a rate of interest of 3 month Prague Interbank Offered Rate ("**Pribor**") plus 2%. The bank loans are repayable without penalty at any time, but fully repayable by 15 March 2019.

[1] The customers are actually invoiced in Romanian Leu, however, the invoice amount reflects fully movements in the USD/Romanian Leu exchange rate.

Given that Orion's functional currency is CZK, it has entered into a cross currency swap in order to swap the fixed rate Euro proceeds from its bond issue due 2021 into fixed rate CZK proceeds. This cross currency swap appears to be out of the money by around EUR 36 million reflecting the appreciation of CZK versus the Euro since the bonds were issued.

3 Public bond debt

Both the Orion notes and the MHBV notes are rated in accordance with their indentures, which set out the terms and conditions of the notes. However, both are rated sub investment grade (i.e. less than BBB-) and in contrast to Victor's BBB+ investment grade rating. The Orion Notes are rated single B and the Mulberry Notes are rated B-. These ratings are 7 and 8 notches respectively below Victor's BBB+ senior debt credit rating.

Despite low credit ratings, both bonds have benefited from an improvement in global credit spreads and are thus trading above par. The Orion notes are trading at a price (excluding accrued interest) which is 110.5% of their nominal value, whilst the MHBV notes are trading at 120% (excluding accrued interest) of their nominal value. Such a price also reflects the fact that the Mulberry notes are callable at 106.25% of nominal value at any time after 31 July 2018. With the current price so much greater than the call price, the bonds are trading as though it is practically certain that they will be called on 31 July 2018, thereby reducing the yield which an investor requires, reflecting the underlying upward sloping interest rate yield curve.

The reduction in both USD and Euro interest rates since the issuance dates of the notes has not been a material driver in explaining the price appreciation of the notes, as in common with other high yield notes, the majority of price movement relates to equity type risk factors.

Both notes also contain a claw back provision whereby up to 35% of the notes can be called at any time if additional equity has been raised by the issuer, thereby providing the funds to redeem the bonds early. This feature was designed to give the borrowing entity the ability to un-gear their capital structure and thus reduce their financial leverage should local mobile market conditions necessitate the need to increase operational leverage.

The call price, in relation to the equity claw-back provision of the Orion notes, is set at 107.5% of nominal value (excluding accrued interest). It is possible to issue both public and private equity to satisfy the claw-back provisions. Furthermore, such private or public equity could be issued from either Orion or OHNV, with any proceeds from equity issuance by OHNV to be on-lent to Orion. The Orion notes also contain a make-whole provision by which all or any notes outstanding can be called at any time, but at a price equivalent to a yield to maturity as derived by adding 0.5% to the yield on a German government bond of similar maturity. This is estimated to equate to a price of 117.4% (excluding accrued interest) of nominal value.

The MHBV notes do not contain a make-whole feature, but they do contain the same flexibility to issue private and public equity to satisfy the claw-back provisions. However, the issuance of equity is restricted to exclude "an affiliate entity". This restriction was drafted so widely that it is almost impossible to envisage a situation where private equity could be issued without breaching the terms of the equity claw-back provision contained in the bond indenture. The

call price in relation to the equity claw-back provision is set at 112.5% (excluding accrued interest) of the nominal value of the notes.

In contemplating whether or not Victor should acquire Teleware there are a number of valuation and Treasury complexities requiring resolution.

4 The enterprise value of Teleware

The market-based enterprise value of Teleware is contentious. Whilst the market capitalization is unambiguous, the market value of debt being assumed by Victor is open to debate. The acquisition of Teleware would improve the implied credit worthiness of both the Orion notes and the MHBV notes, reflecting Victor's far superior credit rating. It is estimated that the MHBV notes would trade up in price to a value equal to 123.25% of their nominal value. Similarly, the Orion notes would be expected to rise in price to 115% of their nominal value.

Thus, even with forecast synergies, it is unclear as to whether the APV of the combined forecast free cash flows available from Mulberry and Orion, together with the valuation of the borrowing tax shield (the "**theoretical enterprise value of Teleware**") exceeds the true cost of acquiring Teleware.

Additionally, it is debatable as to what is the appropriate risk-free rate that should be used in the cost of capital calculations used to derive the theoretical enterprise value of Mulberry. The Romanian government has issued some local currency bonds but liquidity is low and the amount outstanding is also low, thereby requiring a subjective adjustment to the yield on Euro denominated Romanian Eurobonds which are more actively traded, and thus provide an appropriate starting point to derive a local currency risk-free rate.

5 Retaining and refinancing indebtedness

It is probable that following the acquisition of Teleware, the debt at the Orion level would be repaid as far as possible in order to minimize external downstream indebtedness at Orion. However, there were competing arguments as whether the debt at both the MHBV and Mulberry level should be repaid.

From a tax perspective, the low Romanian corporate tax rate makes it uneconomic to retain debt at the Mulberry level. Perhaps more significantly, the Mulberry notes indenture contains highly restrictive covenants and conditions which would amongst other things hamper the ability to reduce equity distributions from Mulberry to MHBV, thereby limiting the amount of debt which Mulberry could support[2]. Mulberry's EBITDA for the year ending 31 December 2016 is forecast to be circa $300 million implying a maximum increase in the debt capacity of the Victor group as a whole (attributable to Mulberry alone) of circa $600m. This reflects Victor's belief that access to extra cash generation through acquisitions increases the group's ability to service debt and thus effectively increases the group's debt capacity, within its

[2] The Romanian public bonds are in MHBV, funded by equity distributions from Mulberry itself. So Mulberry has to remit dividends up to MHBV to satisfy the MHBV bondholders, and this restricts Mulberry's ability to borrow.

targeted single A credit rating (using a very broad rule of thumb of 2x Net Debt : EBITDA consistent with an A rating).

However, the riskiness of Romania as a jurisdiction and as demonstrated by its weak sovereign credit rating of BBB- (lowest investment grade rating) means that there is a strong case for not only retaining the existing MHBV debt and the Mulberry bank loans, but indeed attempting to increase the size of Mulberry's bank facility.

Refinancing the Orion indebtedness would ultimately require Orion to issue equity to OHNV. However, it is estimated that in accordance with Czech Republic law requirements, there could be up to a 6 month delay from the completion of the Teleware acquisition before Orion could issue new equity. Consequently, it is likely that OHNV would issue equity to VIHBV immediately on completion of the Teleware acquisition, with the proceeds temporarily on-lent to Orion to repay its external indebtedness. This would therefore satisfy the terms of the equity claw back feature, whilst at the same time removing downstream indebtedness.

In time, it is envisaged that equity issued by Orion to OHNV would pay off the temporary loan from OHNV. However, in order to ensure that interest received by OHNV from Orion could be offset (from a tax perspective) against the interest payable by VIHBV to Victor Plc (interest on the acquisition consideration) it is essential that OHNV and VIHBV are in a "fiscal unity" relationship. This will entail changing the functional currency of OHNV from CZK to Euro. This in turn means that (i) Orion's cross currency swap will have to be unwound and (ii) there will need to be some forex hedge overlay to accommodate the fact that Orion will have a foreign exchange exposure caused by borrowing Euros from OHNV, until the time it can issue equity to repay the OHNV temporary loan.

6 Insurance

At the time of discussing the potential acquisition, group insurance learned that Orion had insurance cover with AIG, running until 1 November 2017 and similarly Mulberry had cover with AIG and Allianz running until 31 December 2017. The premium on both policies reflected stand-alone arm's length pricing.

7 Additional background information

These exhibits comprise edited highlights from the acquisition dossier.

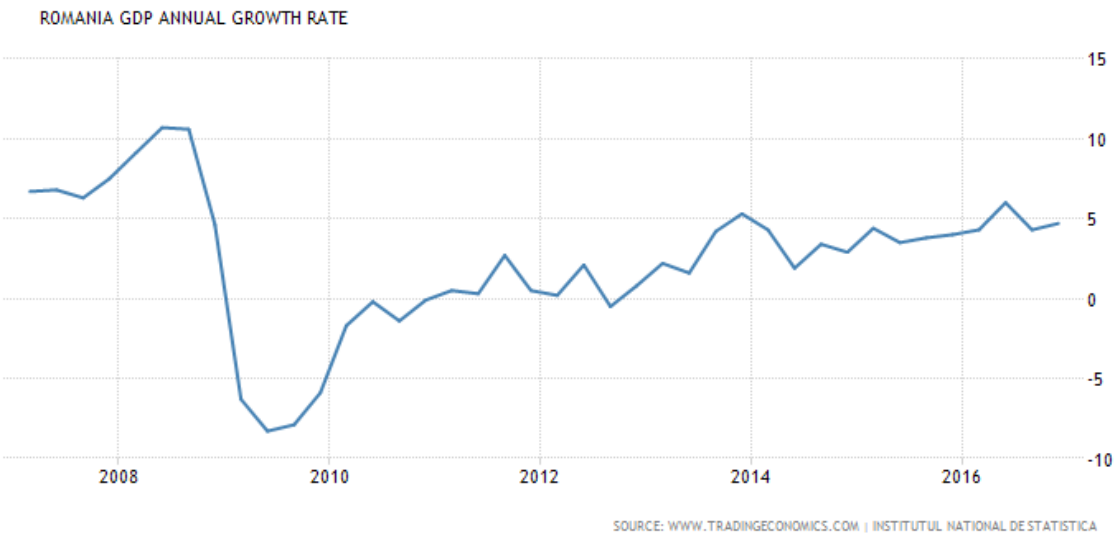
Exhibit 2: Integration Issues

Mulberry	Integration issues with Mulberry are expected to be limited although including the fixed line offering into a unified package may be challenging. Mulberry is well known to Victor Victor already has a 20% interest in Mulberry Victor is represented on the Board and appoints the CFO Mulberry has a high corporate customer base and a strong market share - consistent with Victor's aspirations in a number of other markets
Compatibility of Orion within the Victor Group	Orion is an aggressive, innovative third operator which has been able to gain 17% market share within five years of operation Operations are run at relatively low cost Focus on SMEs and younger consumers—seen as cult brand Additional focus on larger enterprise customers It may prove hard to integrate Orion into the Victor Group, especially when the fixed line offering is included in a unified package However, Orion does have a high proportion of post-pay customers with relatively high RPU (20% revenue share on 17% market share in 2015) Also, Orion has approximately 49% of 20–29 year old post-pay market, attractive customers which should fit well within the Victor Group Victor has the opportunity to deploy Victor's Hungary strategy to Orion
Transition risk in Orion	Orion's senior management is largely made up of expatriates from the UK with each of the CEO, COO and CFO being Teleware secondees. Part of the success of the business is attributable to the leadership of the COO who is unlikely to stay with the business in the medium term

Exhibit 3: Economic Snapshot of Romania and the Czech Republic

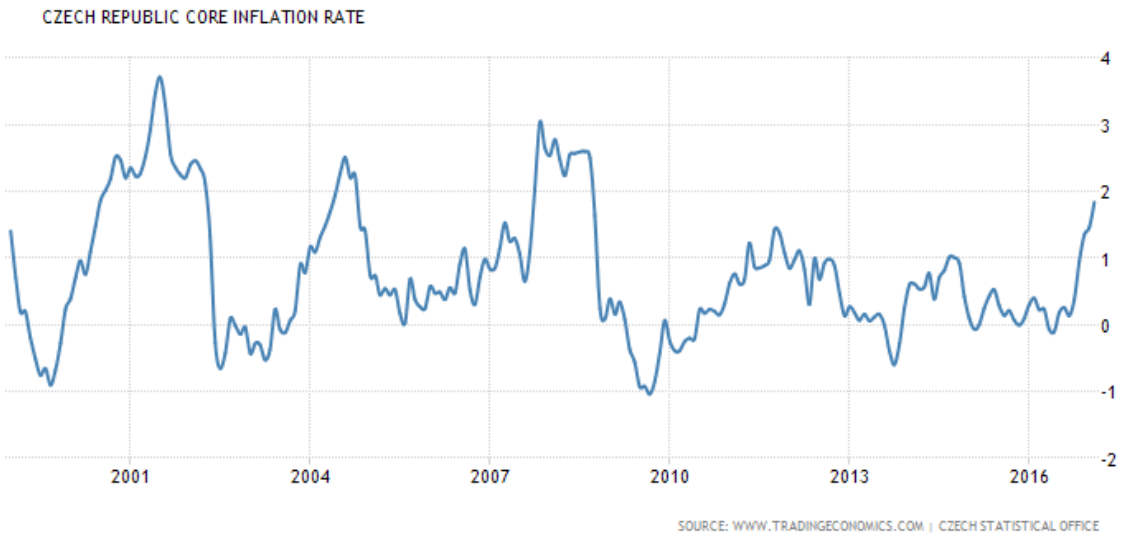
Romania – Sovereign Credit Rating BBB- / Baa3 / BBB-

- A relatively stable political system, with the last election held in 2012 and presidential election held in 2014.
- The government introduced a lower, flat tax rate of 16% for corporate and income taxes (from 25% and 18-40% previously)
- Joined EU January 2007
- Currency fully convertible; member of ERM-2 (prior to joining the Euro)
- Annual growth expected at around 2 to 3%



Czech Republic –Sovereign Credit Rating A1 / AA- / A+

- Joined EU in May 2004
- One of the most stable and prosperous among all the post-Communist states
- EU harmonisation drive will continue to set course for economic policy
- Strong Real GDP growth of 2 to 3% anticipated over the medium term



Population comparisons to other Eastern European nations

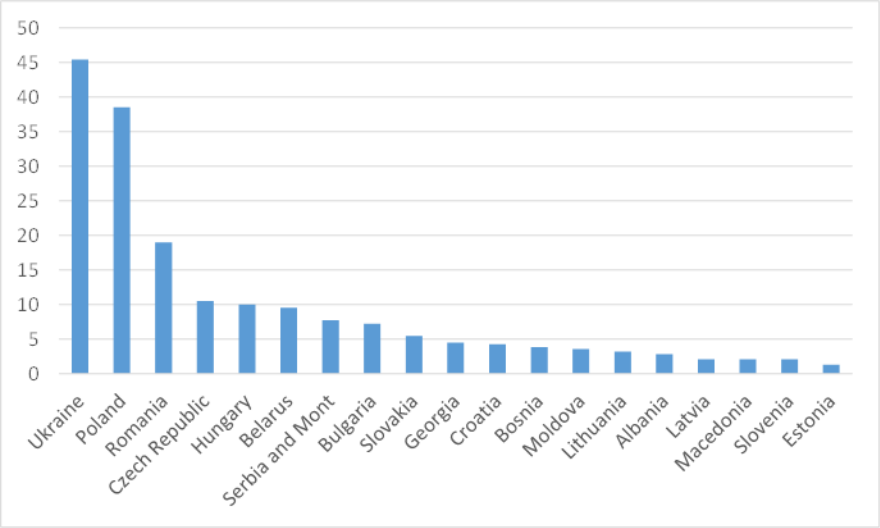


Exhibit 4: Terms of the Mulberry and Orion notes

	Mulberry Notes	Orion Notes
Issue / Interest Accrual Start Date	27 June 2010	13 Oct 2011
Maturity Date	31 July 2020	15 Oct 2021
First Coupon date	31 Jan 2011	15 April 2012
Coupon	12.5%	7.5%
Coupon Frequency	S/A	S/A
Day Count	30 / 360	30 / 360
Issue Price	100	100
Call Features	• 31 July 2018 @ 106.25 • (35% max) w prcds of equity offer @ 112.5%	• make whole + 50 bps • (35% max) w prcds of equity offer @ 107.5%
Rating	B-	B
Issue Size	$225,000,000	€325,000,000
Spread at Issue versus mid swaps	900 bps	380 bps
Redemption Price	100% of nominal value	100% of nominal value
Currency	USD	Euro

Exhibit 5: Czech Republic Government Bonds yield curve as at 1 January 2017

Term	Yield
3 months	**0.03%**
6 months	**0.05%**
1 year	**0.05%**
2 years	**-0.044%**
3 years	**0.014%**
5 years	**0.12%**
10 years	**0.50%**
15 years	**0.79%**
50 years	**1.93%**

Exhibit 6: Romanian domestic and Eurobond yields as at 1 January 2017

Term	Domestic	Euro
6 months	**0.5%**	
1 year	**0.72%**	
2 years		**0.0%**
3 years	**1.92%**	
5 years	**2.79%**	**1.0%**
10 years	**3.74%**	