4.6.2 Foreign Exchange Translation Exposure Exercise

Unit: Unit 1 – Treasury strategy

Module: Module 4 – Financial risk

Date: 1 March 2012

Summary: An exercise in translation risk.

Keywords: EBITDA, sources of funds, uses of funds

In 2008, Playwell Ltd, a UK based company decides to make an acquisition in Europe (the assets of Playhard SpA) to expand its market for its popular new products. Playwell (pre-acquisition) has the following basic operating characteristics:

Playwell	**£m**
Operating assets	90
Net cash	16
EBITDA	10
Interest rate for sterling cash and debt	7%

The characteristics of the acquisition, for which the debt free purchase price is €100m, are as follows:

Playhard	**€m**
Operating assets	100
EBITDA	12
Interest rate for euro cash and debt	7%

Playwell's financial controller has advised that he is concerned about the translation risk and cites concerns over the movement in Playhard's assets of €100m and the translation of the European EBITDA. Management accordingly decides to finance the acquisitions almost entirely with Euro debt. The transaction is managed as follows, when the exchange rate is €1.50 = £1.00:

© Association of Corporate Treasurers

	£m	€m
Sources of funds		
Cash from UK balance sheet	6	
FX transaction proceeds		9
Debt drawdown		91
Total	**6**	**100**
Uses of funds		
FX transaction sterling sold	6	
Acquisition		100
Total	**6**	**100**

Question 1
Using the accompanying exercise proforma spreadsheet - the tab named "Consolidation at 1.50" - calculate the following profitability and credit measure ratios for Playwell following the acquisition:

- earnings
- net worth = Equity
- gearing (debt /equity)
- net debt / EBITDA
- interest cover

Comment on the results.

Question 2
Following the financial crisis, the GBP / EUR exchange rate has moved to 1.10. Using the exercise proforma spreadsheet - the tab named "Consolidation at 1.50 and 1.10" - calculate the following profitability and credit measure ratios for the consolidated Playwell following the fall in sterling:

- earnings
- net worth = Equity
- gearing (debt /equity)
- net debt / EBITDA
- interest cover

Comment on the results.

© Association of Corporate Treasurers