3.4.2 Devising a Financial Strategy for Yule Catto from Scratch Exercise

Unit: Unit 1 – Treasury Strategy

Module: Module 3 – Financial strategy

Date: 1 March 2012

Summary: An exercise in writing a financial strategy.

Keywords: capital structure, equity, liquidity, PEST analysis, product life cycle, environment matrix, Porter's five forces, enterprise value, EBITDA, leverage, credit rating, peer group, financial flexibility, dividend policy, debt markets, bank relationships, foreign exchange policy, interest rate policy, pension policy

Devise a financial strategy for Yule Catto. You are not bound by the existing capital structure and can choose whatever level of equity you like. Assume that there is liquidity in that market.

We have sourced the following information for you to help in this analysis:

- Detailed analysis of accounts for 7 years up to 2010[1] (see below).
- Morgan Stanley report dated 14 March 2011

You should ignore the rights issue and acquisition that was announced in late 2010, so that you can assume that the business will remain as it is at end 2010. However, the very fact that an acquisition has been made can be an indication of part of the strategy.

The pension scheme, however, cannot be changed.

Assume that:

- geared beta is 1.52
- the risk free rate is 2.5%
- the equity premium is 4.5%
- the cost of debt for Yule Catto is 3%
- the underlying tax rate is 19% (seen on p12 of the 2010 accounts)

The assumption of a flat 19% tax rate might be unrealistic in that tax rates vary across the countries of operation and in fact corporates spend a lot of energy juggling debt with suitably high tax rates. The assumption is good enough for this exercise.

[1] We restrict our analysis to the end of 2010 because Yule Catto announced a major acquisition in December 2010 and following this, it is difficult to establish trends.

Work from the closing share price at December 2010 of 249p.

	2004	2004 IFRS	2005	2006	2007	2008	2009	2010
Sales	549,444		568,707	565,786	580,641	602,153	543,398	651,480
Gross profit	124,074		124,935	117,889	117,955	116,089	128,029	136,347
Distribution costs	(44,686)		(47,268)	(43,501)	(44,083)	(46,088)	(42,969)	(46,539)
Admin costs	(37,383)		(31,474)	(31,429)	(27,858)	(26,809)	(33,654)	(34,033)
Employees	3,426		3,051	2,755	2,672	2,485	2,093	1,872
Employee cost	88,231		83,659	72,417	70,760	73,163	63,674	62,289
Operating profit	42,005		46,193	42,959	46,014	43,192	51,406	63,006
Interest	(12,950)		(11,741)	(11,443)	(11,497)	(10,502)	(9,869)	(7,840)
Profit before tax	31,011		32,031	31,516	34,517	32,690	41,537	57,811
Tax	(9,613)		(8,998)	(8,855)	(7,646)	(4,904)	(8,261)	(2,537)
Lease rentals	4,923		4,835	4,271	4,701	4,360	5,048	5,131
Underlying EBITDA	66,871		65,504	61,272	62,027	58,630	66,082	69,503
CAPEX	16,920		14,331	18,468	16,994	17,707	8,687	10,592
Depreciation	20,087		18,984	18,086	15,766	15,336	14,345	14,315
Balance sheet								
Goodwill	216,352	172,443	172,443	172,443	172,443	154,027	124,027	124,027
Fixed assets	166,440	148,729	140,064	110,167	108,468	118,106	103,815	102,568
Stocks	71,235	70,907	66,495	66,080	65,001	63,507	56,145	65,379
Debtors	109,492	109,517	103,244	105,166	115,078	126,136	99,006	111,285
Trade Creditors	(79,412)	(79,412)	(77,063)	(83,513)	(89,964)	(100,790)	(78,961)	(90,880)
Other creditors	(42,873)	(43,233)	(52,460)	(41,379)	(58,336)	(51,831)	(46,648)	(49,199)
Taxation	(44,073)	(52,512)	(53,050)	(52,100)	(48,948)	(44,528)	(34,556)	(28,763)
Cash	17,834	93,868	46,027	65,917	108,352	26,576	42,384	36,211
Short debt	(26,210)	(102,244)	(37,385)	(57,802)	(133,585)	(57,972)	(38,924)	(9,876)
Long debt	(179,265)	(170,161)	(179,908)	(158,771)	(125,108)	(130,052)	(101,106)	(102,379)
Net pension		(75,802)	(69,637)	(77,884)	(41,236)	(75,559)	(78,689)	(65,997)
Other	(35,567)	(26,181)	(3,264)	(24,106)	(26,562)	39,072	8,044	20,189
Net worth	173,953	45,919	55,506	24,218	45,603	66,692	54,537	112,565
Market Value	409,900	409,900	382,000	337,600	274,100	80,100	221,408	428,352
Enterprise Value	602,000	602,000	552,300	507,900	450,600	224,700	316,300	498,000
Underlying borrowings		(178,537)	(165,591)	(166,271)	(170,831)	(135,482)	(88,038)	(63,370)
Pension deficit UK	43.5		57.6	69.3	33.6	67.4	70	56.5
Pension deficit Other	6.7		12	8.6	7.6	8.1	8.7	9.5
KEY RATIOS	**2004**	**2004 IFRS**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Gross profit / sales	22.6%		22.0%	20.8%	20.3%	19.3%	23.6%	20.9%
Dist costs / sales	8.1%		8.3%	7.7%	7.6%	7.7%	7.9%	7.1%
Admin costs / sales	6.8%		5.5%	5.6%	4.8%	4.5%	6.2%	5.2%
EV / Sales	1.10		0.97	0.90	0.78	0.37	0.58	0.38
EV / EBITDA			8.43	8.29	7.26	3.83	4.79	7.17
Sales / employee	160.37		186.40	205.37	217.31	242.32	259.63	348.01
Employee cost / Sales	16.1%		14.7%	12.8%	12.2%	12.2%	11.7%	9.6%
Operating profit /Sales	7.6%		8.1%	7.6%	7.9%	7.2%	9.5%	9.7%
Tax rate	31.0%		28.1%	28.1%	22.2%	15.0%	19.9%	4.4%
Sales / EBITDA	8.22		8.68	9.23	9.36	10.27	8.22	9.37
Debt / EBITDA	2.67		2.53	2.71	2.75	2.31	1.33	0.91
Sales / Fixed Assets	3.69		4.06	5.14	5.35	5.10	5.23	6.35
Working capital / Sales	18.4%		16.3%	15.5%	15.5%	14.8%	14.0%	13.2%
Debt / enterprise value	29.7%		30.0%	32.7%	37.9%	60.3%	27.8%	12.7%
Market / Book	8.93		6.88	13.94	6.01	1.20	4.06	3.81
Capital employed	224,456		221,097	190,489	216,434	202,174	142,575	175,935
EBITDA / Capital employed	29.8%		29.6%	32.2%	28.7%	29.0%	46.3%	39.5%
EBITDA / Enterprise value	11.1%		11.9%	12.1%	13.8%	26.1%	20.9%	14.0%
EBITDA less CAPEX	49,951		51,173	42,804	45,033	40,923	57,395	58,911
EBITDA / Interest	5.16		5.58	5.35	5.40	5.58	6.70	8.87

Student Notes

This would be a wonderful opportunity, if you ever had it, to devise a financial strategy from scratch. You have a blank sheet of paper but the following rough steps are one possible route that you could follow to come up with the strategy.

We do not expect calculations to be in any real detail, approximations and assumptions are quite valid in reaching the stage that we want you to reach. It is the strategy, rather than the detail that we need to get to here.

There is no 'right' answer to this question, but the exploration of ideas that occurs when undertaking this sort of research is designed to make you think more like a treasurer. Some alternative approaches are considered in the answer.

You may find it helpful to refer back to the analysis of Yule Catto in Exercise 1.2.1.

1. Analyse the business strategically, from a business point of view
   - 1.1. Following the procedure as set out in Section 3 of reading 1.3.1, consider:
     - 1.1.1. PEST Analysis
     - 1.1.2. Product life cycle
     - 1.1.3. Environment matrix
     - 1.1.4. Porter's 5 forces
     - 1.1.5. Conclusions
   - 1.2. Risks
   - 1.3. Competitors and peers
   - 1.4. What is its geography?
   - 1.5. What will be its challenges over the coming years?
   - 1.6. Who might invest in this?
   - 1.7. How is the sector consolidating?

2. Establish some basic financial measures for the business
   - 2.1. What is the enterprise value?
   - 2.2. What is EBITDA?
   - 2.3. What is the ideal capital expenditure level?
   - 2.4. What return on equity is required? Time to dust off that calculator! (See spreadsheet: 3.4.2 Financing Yule Catto from scratch leverage to WACC MODEL ANSWER
   - 2.5. What leverage should be targeted?
   - 2.6. Should we target a credit rating?
   - 2.7. What do the peer group companies do?
   - 2.8. What is the life cycle of the company and its products?
   - 2.9. What financial flexibility do we need?
   - 2.10. What other products are required from the financial sector?

3. Establish some conclusions
   - 3.1. Leverage?
   - 3.2. Ideal dividend policy

3.3. Debt markets to tap
3.4. Bank relationships
3.5. International cash management structure
3.6. What corporate structure for subsidiaries and other investments
3.7. Foreign exchange policy
3.8. Interest rate policy
3.9. Pension policy

The accompanying spreadsheet can be used to calculate a WACC for a given leverage (of debt / (debt + equity)) and which can be used in goalseek mode to achieve a given WACC.