4.2.2 Risk Identification and Assessment Exercise

Unit: Unit 1 – Treasury Strategy

Module: Module 4 – Financial risk

Date: 1 March 2012

Summary: An exercise in identifying and assessing risk

Keywords: risk identification, budgetary process, management accounts, risk mapping, probability, impact, expected value

This exercise in risk identification and assessment is based on an actual case study examination question. This follows the format adopted in the exam where there is some very detailed background information which requires analysis and interpretation. Questions are then asked on various treasury topics. This exercise is based on Leisure Tours plc.

In this exercise we have retained the marking scheme against the questions to indicate the time / effort allowed according to the marks.

We return to this same company in Exercises 4.4.2 and 4.4.4.

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

Question 2
Leisure Tours plc 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 Leisure Tours plc
b) How material is each type of risk for Leisure Tours plc? Quantify and indicate the level of sensitivity, noting any assumptions made.

Student notes
This is useful practice for the actual exam question. Remember that in the exam you will have little time to write an answer but you will have had a week to study the background material in some detail. In this exercise we have set aside two hours in total for the reading and for writing down the answer. You must therefore be very quick, but reading certain things very quickly is a core skill for most professions.
To help you in this exercise, especially with regard to time, we have removed from the background material anything which was not really necessary to answer the question.

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Background information

Based on Leisure Tours plc (LT)

October 2010 MCT Case Exam

INTRODUCTION

Leisure Tours (LT) and Worldwise plc (WW) are the two major tour operators in the UK. Both companies are the result of mergers in 2007: Leisure Tours AG with Monroe plc and Worldwise plc with Primera plc.

LT summary financials at year-end 30 September 2009 were:

	£m
Sales revenue	9269
Operating profit pre exceptionals	419
Exceptionals (mainly merger-related)	216
Operating profit	203
EBIT	160
PBT	56
PAT	18
Market capitalisation	1823
Net debt (Debt 1225m - Cash 550m)	675

Note that the September year-end more-or-less reflects the "completion" of one year's cash cycle and the start of the next.

In 2009 LT had 22.1m customers and employed 31,000. It operates in five geographic segments (21 countries) with a network of 3,400 owned and franchised travel stores and a fleet of 95 aircraft.

TOUR OPERATING SECTOR[1]

In the purest form tour operators are holiday organisers that arrange flights, accommodation, transfers and car hire, put them into packages and sell them for a commission. The model has become more complex over the years as companies have expanded vertically into owning the airline and the travel agent – covering most parts of the value chain excluding hotels. There are five main components of a tour operator:

- Hotels – usually arranged rather than owned – treated as a pass through cost with no margin
- Airline – the large operators own the airline and make good margins
- Distribution – the large operators run both high street and online travel agencies – with small margins
- Tour operator – the key administration centre putting packages together
- Destination services – often in resort services are controlled by the tour operator – and make good margins.

It is quite difficult to get an accurate breakdown of the costs and revenues associated with each part of the tour operating business. Worldwise plc has provided targets for its planned cost of distribution and admin that we show below (and in Figure 1):

[1] Note 1: Section 2.0 data and opinions are drawn largely from a Bank Equity Analyst's Report.

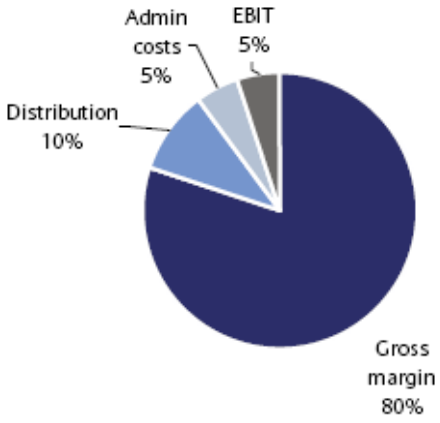
- GP1 – 20% - gross profit after accommodation, destination and airline costs
- GP2 – 10% - includes selling and distribution costs of c10%
- GP3 – 5% - after admin – i.e. tour operator 5%

While at the last results presentations Leisure Tours showed its breakdown of gross margin:

- **Accommodation** – 33% of sales
- **Aviation** - 37% (includes fuel at 8%) of sales
- **Other cost of sales** – 7% - mainly destination services
- **Selling and administration costs** – 18%

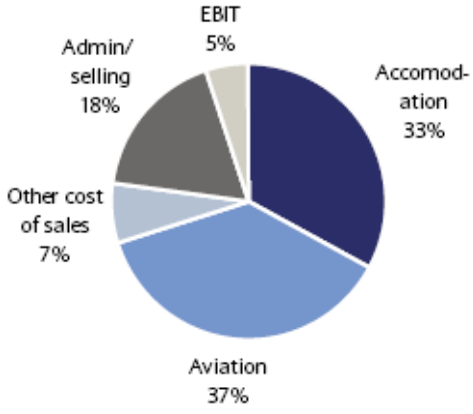
We show these in Figures 1 and 2.

Figure 1: Worldwise plc margin breakdown target



Source: Worldwise plc

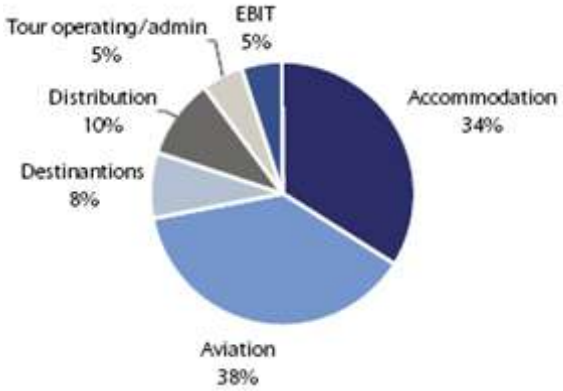
Figure 2: Leisure Tours plc margin breakdown 2008



Source: Leisure Tours plc

If we assume that the two companies are fairly similar – we can put both of these parts together to get a reasonable view on the split of the cost base as a percentage of sales that we show in Figure 3.

Figure 3: Estimated breakdown of costs - % sales, 2008



Source: Barclays Capital

Hotels - c34% of revenue

The hotel cost for both Worldwise plc and Leisure Tours plc is mainly a pass-through cost. Very few hotels are owned or leased by either group - although they can manage hotels. In exceptional circumstances they may have to guarantee rooms in an important location. Some hotels are branded for exclusive use of an individual tour operator that would have some guarantees in place. Guarantees account for 20% of Worldwise plc travel's bed requirements whilst just 10% of Leisure Tours. These beds tend to be filled first in the booking system to help minimise the risk. Ironically, hotels have the largest margin in the value chain with tourism units enjoying a 30-35% EBIT margin.

The tour operators have tried - with varying degrees of success - to invest in hotels to monetise this part of the value chain.

- Monroe plc - tried it five years ago with some significant hotel purchases but had to sell them when they hit financial problems.
- Worldwise AG - still owns some hotels that were part of the tour operating division but were not consolidated into Worldwise plc at the merger. However, Worldwise AG has arms length agreements with Worldwise plc to fill the rooms.
- Primera plc - negotiated an option with a Spanish Hotelier to acquire hotels but the option expired.

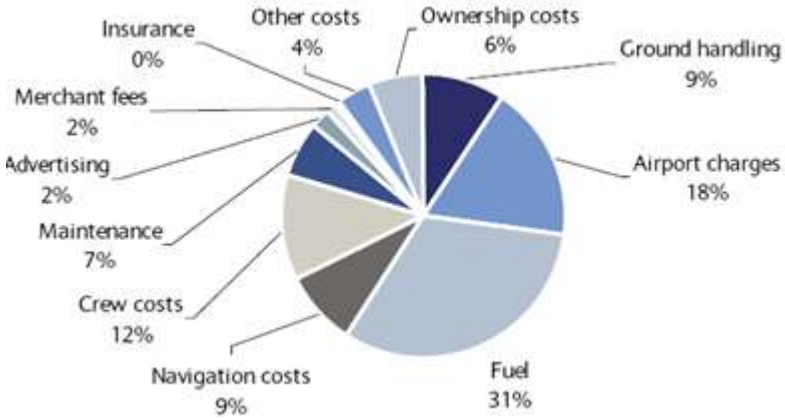
Some believe that it has never really worked with the high capital cost being one issue and the lack of flexibility being another. Committing to hotel beds significantly increases the risks in the business - especially if the beds are in places that go out of fashion. This was probably one of the factors that triggered Monroe plc's capital restructuring debt for equity swap.

Airline - c38% of revenue

Both Worldwise plc and Leisure Tours plc own an airline. The costs of this are mainly fixed once the decision to fly the plane has been made. We show the breakdown of easyJet's cost base in figure 4. With the exception of merchant fees (credit card payment fees) and advertising, all the costs would have to be paid if the aircraft is flown empty. The key to a variable cost base is the ability to be flexible on capacity, as we describe later in the note. The tour operators have been successful in ensuring flexibility on the airline fleet. This has been achieved from two areas in the airline:

- Staggered annual lease expiry.
- Non-committed seats on third-party carriers - Worldwise plc has 30% from third-party flying in the mainstream operations across its operations with both companies having c10% in the UK.

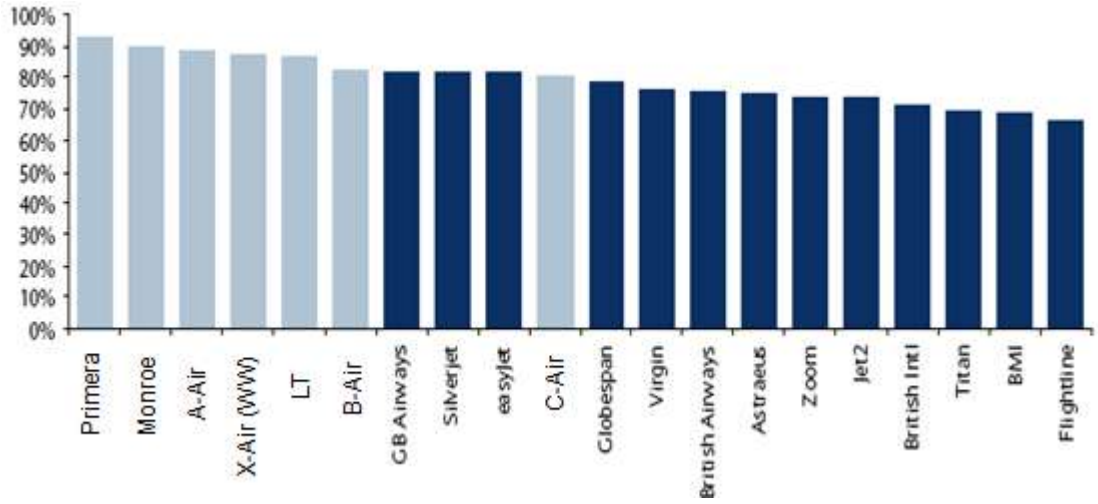
Figure 4: easyJet cost base of its airline



Source: easyJet report & accounts, 2008

In general – the tour operators are good operators. Load factors are high due to extensive distribution offered by the retail travel agents and tour operating function that is designed to ensure that the planes are flown full. This high utilisation of the aircraft is depicted in figure 5. The data comes from CAA data for 2007, which shows the average utilisation of the top 20 based airlines. The charter operators are highlighted in a lighter colour – but it is clear that they have very high load factors relative to the scheduled operators.

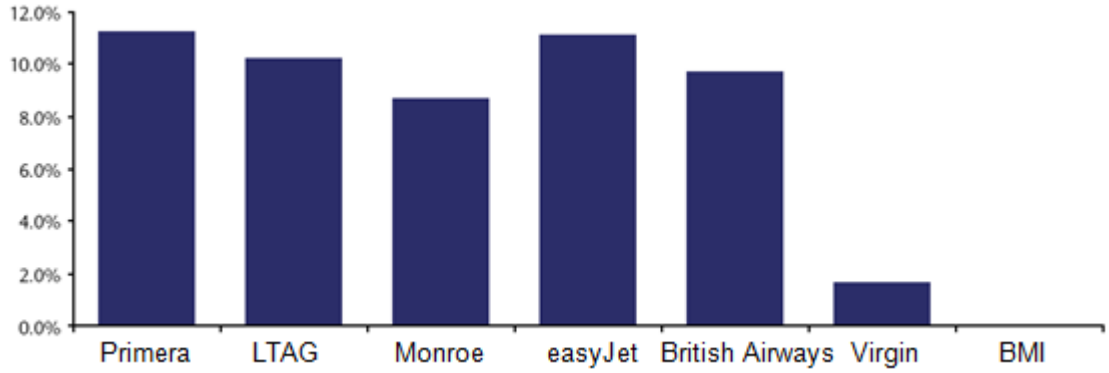
Figure 5: Load factors of the top 20 UK airlines



Source: CAA

The high load factors also produce good EBIT margins as we show in figure 6. In 2007, the margin of the charter airlines were very similar to the top UK scheduled carriers of British Airways and easyJet - and substantially ahead of Virgin and BMI. X-Air (WW) is not included in the data as it had major losses from its scheduled operation and exceptionals that cannot be split from the CAA data.

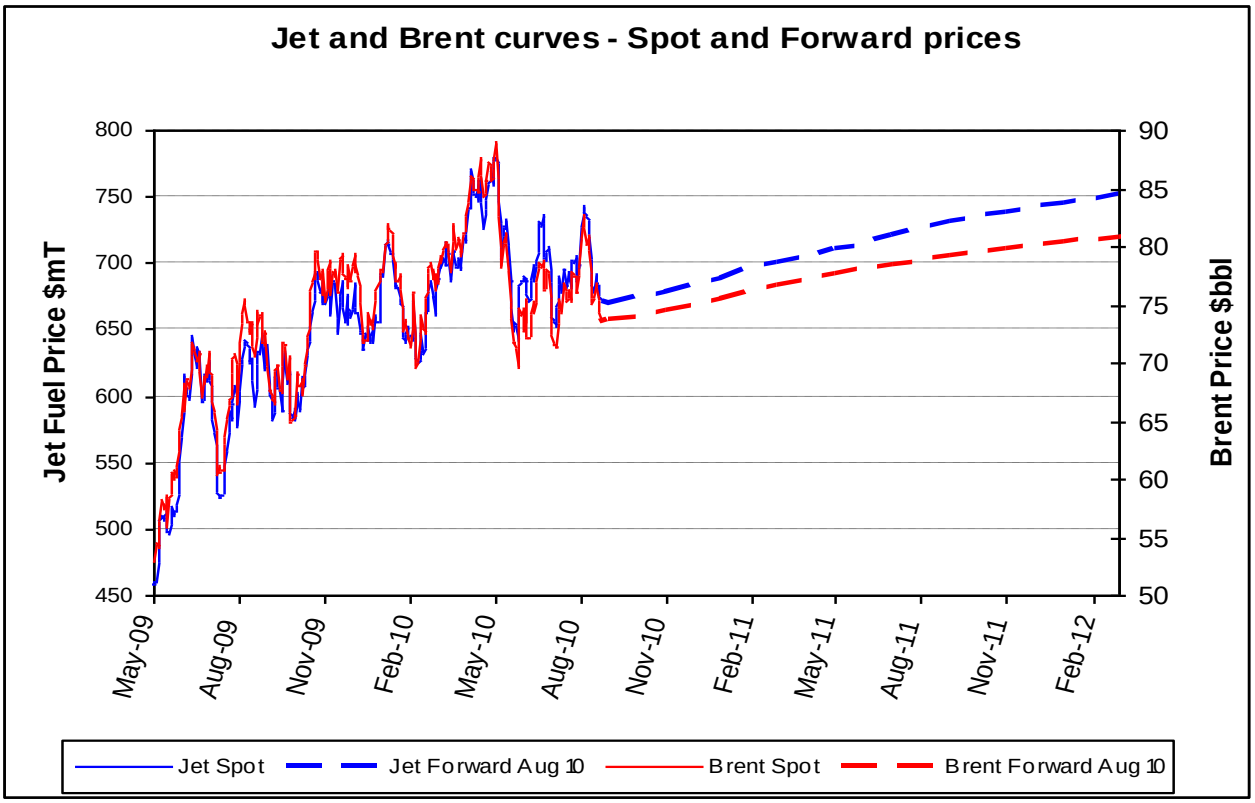
Figure 6: EBIT margin of the major UK airlines, 2007



Source: CAA data

Fuel is a very significant element of airline costs because of its size and volatility. The graph below shows spot prices over the past year to August 2010 and forward prices out to February 2012

Figure 7: Jet and Brent spot and forward prices



Jet and Brent are quoted in different units.

Destination services - c8% of costs

Destination Services is an important part of the product differential from a modular package. This includes in resort representatives that provide entertainment as well as support and help sales on trips in the resort. X-Air (part of Worldwise Travel) adopted a policy of ensuring that all reps covered their costs with sales of in resort services.

Distribution costs - c10% of costs

Distribution costs are an area that differentiates the tour operators' business model from an airline. The easyJet split of costs in figure 4 shows that merchant fees (i.e. credit card costs etc) together with advertising totalled 4% of costs, which accounts for most of the distribution costs of the group. This is significantly smaller than 10% for the tour operators - and in fact it would be nearer 15% if the cost of hotels is excluded to put it on more of a like-for-like basis with the airlines. This is not surprising given that easyJet's only real form of distribution is from online bookings. Tour operators own a large number of travel agents in the high street, which materially increases the cost of distribution, although arguably they have proved to be more successful at filling the planes as we showed in the load factors. The travel agent has a similar cost profile to a retailer with rent and staff costs accounting for more than 50% of the costs. Most of the high street shops are leased with both Worldwise plc and Leisure Tours plc having a staggered lease expiry guaranteeing some flexibility. Increasing the percentage of bookings from both owned distribution and the online percentage is a major focus of both Worldwise plc and Leisure Tours plc.

Tour operating costs - c5% of costs

The tour operator is effectively an administration cost. This part of the operation puts itineraries together, decides where the planes would be best utilised and in which resorts. It makes agreements with hotels and controls pricing of the packages to ensure they are sold at the maximum margin. For doing all of this the margins are typically very low as it actually takes on very little risk and requires limited capital.

Margin depends on the level of integration

The level of margin for a tour operator varies geographically due mainly to the different degree of vertical integration. The more parts of the value chain that they keep - the higher the margin. Not surprisingly this increases the level of risk in the group too. A good way of demonstrating this is with Leisure Tours that showed the margin targets for each of its main geographical areas that we show in the table below.

Margin range determined by business type

Type	Leisure Tours segment	Industry margin %
Fully integrated (TO*, Shops, Airline & Hotels)	Northern Europe	7 - 9
Highly integrated (TO*, Shops & Airline)	UK Belgium	5 - 8
Less integrated (TO* & Retail)	Netherlands France Canada	3 - 5
Emerging markets	Eastern Europe	2 - 4
Tour operators only	Germany	2 - 3
Airline	LT (Germany)	4 - 6
Germany combined		3 - 5

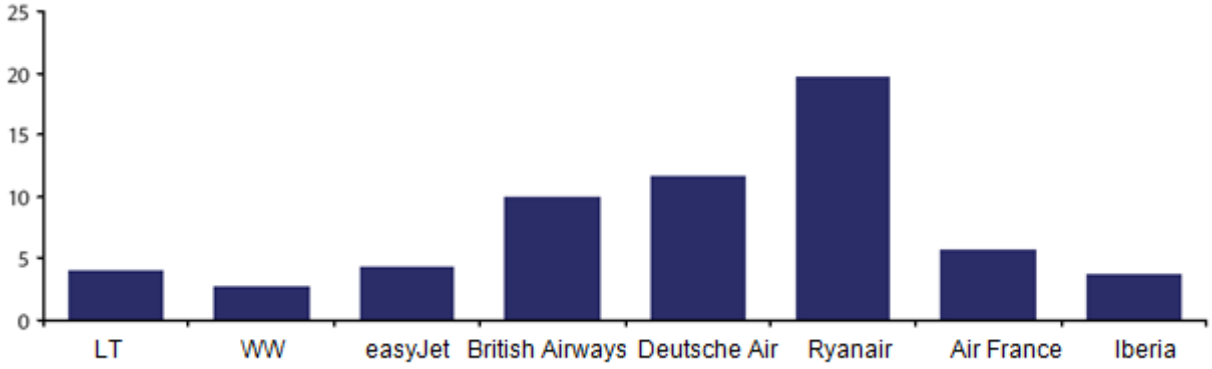
*** Tour operators (TO)**

Source: Leisure Tours

- **Fully integrated** – 7% to 9% – the group's Scandinavian operation included some hotel participants together with the tour operating, retail and airline operations. This enables the group to target a margin of 7-9% (the largest of all geographical regions) – and actually achieved 8.9% in 2008.
- **Highly integrated** – 5% to 8% – the UK and Belgium operations include the tour operator, airline and travel agencies giving a 5-8% margin opportunity.
- **Less integrated** – 3% to 5% – the groups' operations in Netherlands, France and Canada only include the retail travel agent and tour operator – hence a lower margin.
- **Emerging market** – 2% to 4% – small and in development.
- **Tour operators only** – 2% to 3% – the German operation has limited vertical integration and makes a low but relatively low risk margin.
- **German airline** – 4% to 6% – due to competition in Germany – the airline has modest margin targets.

The tour operator groups look to have worse margins than the airline operators – although this is distorted by the pass-through cost of the hotels. Taking the distribution and selling costs on top of the airline margin we showed earlier, the tour operators made a 5.5% to 6.5% margin last year. While this is below the better airline operators, we believe the additional costs of distribution make the groups more resilient to the downturn.

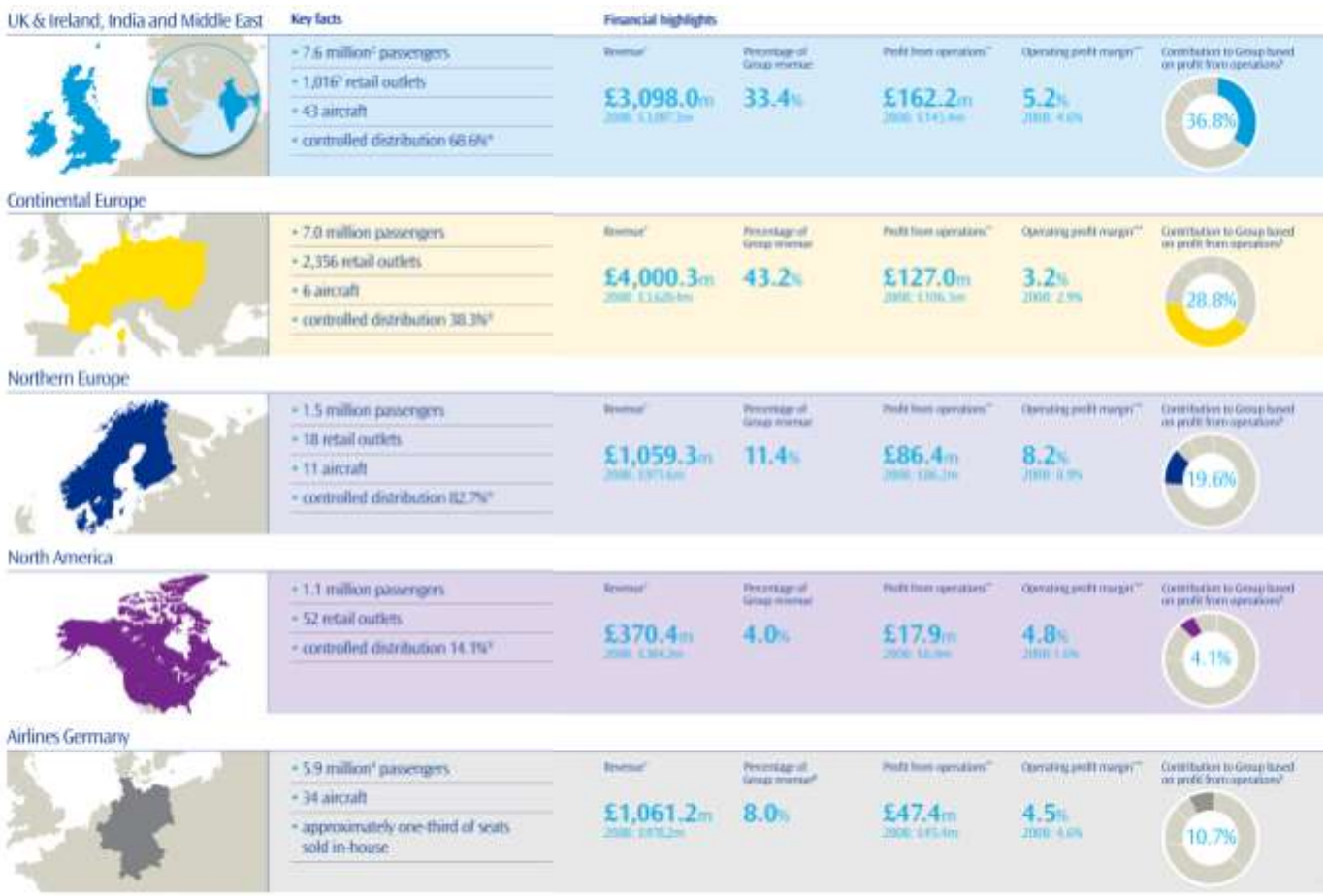
Figure 8: Airlines' margins against the tour operators, 2007



Source: Barclays capital

Group Overview 2009

Leisure Tours plc is one of the world's leading leisure travel groups with sales of £9.3 billion and 22.1 million customers. LT operates under five geographic segments in 21 countries, and is number one or number two in its core markets. The business is supported by 31,000 employees, a fleet of 95 aircraft and a network of over 3,400 owned and franchised travel stores.



Segmental information

For management purposes, the Group is currently organised into five geographic operating divisions: UK and Ireland, Continental Europe, Northern Europe, North America and Airlines Germany. These divisions are the basis on which the Group reports its primary segment information. Certain residual businesses and corporate functions are not allocated to these divisions and are shown separately as Corporate.

The primary business of all of these operating divisions is the provision of leisure travel services and, accordingly, no separate secondary segmental information is provided.

Segmental information for these activities is presented below:

Primary segments – management structure

Year ended 30 September 2009	UK and Ireland £m	Continental Europe £m	Northern Europe £m	North America £m	Airlines Germany £m	Corporate £m	Total £m
Revenue							
Segment sales	3,117.2	4,014.6	1,061.6	370.4	1,061.2	–	9,625.0
Inter-segment sales	(19.2)	(14.3)	(2.3)	–	(320.4)	–	(356.2)
Total revenue	3,098.0	4,000.3	1,059.3	370.4	740.8	–	9,268.8
Result							
Profit/(loss) from operations before exceptional items and amortisation of business combination intangibles	162.2	127.0	86.4	17.9	47.4	(26.0)	414.9
Exceptional items	(88.8)	(64.6)	(7.3)	(22.8)	(3.4)	(29.0)	(215.9)
Amortisation of business combination intangibles	(14.2)	(0.5)	(18.9)	(1.2)	–	–	(34.8)
Segment result	59.2	61.9	60.2	(6.1)	44.0	(55.0)	164.2
Share of results of associates and joint ventures							(3.8)
Loss on disposal of associate							(2.2)
Net investment income							1.4
Finance income							51.2
Finance costs							(154.7)
Profit before tax							56.1
Tax							(37.8)
Profit for the year							18.3
Other information							
Capital additions	63.4	22.8	10.3	5.0	63.1	33.4	198.0
Depreciation	47.7	11.1	9.2	1.0	74.8	1.4	145.2
Amortisation of intangible assets	24.3	5.3	19.5	2.0	0.3	5.8	57.2
Impairment of intangible assets	–	0.8	–	–	–	17.2	18.0

Balance sheet							
Assets							
Segment assets	3,833.0	1,869.3	1,659.2	318.8	876.9	3,763.3	12,320.5
Inter-segment eliminations							(5,761.2)
							6,559.3
Investments in associates and joint ventures							36.0
Tax and deferred tax assets							476.0
Total assets							7,071.3
Liabilities							
Segment liabilities	2,643.6	1,289.2	917.3	270.1	617.6	2,939.1	8,676.9
Inter-segment eliminations							(4,750.7)
							3,926.2
Tax and deferred tax liabilities							192.4
Borrowings and obligations under finance leases							1,225.5
Total liabilities							5,344.1

Inter-segment sales are charged at prevailing market prices.

Segment assets consist primarily of goodwill, other intangible assets, property, plant and equipment, trade and other receivables and cash and cash equivalents.

Segment liabilities comprise trade and other payables, revenue received in advance and provisions.

Capital additions comprise additions to property, plant and equipment and other intangible assets.

Performance Highlights 2009
Financial services performance continued to be strong helped by share gain in the UK foreign exchange market, and continued initiatives to improve insurance cross-sell rates.

Capture Growth and Value through M&A and Partnerships
To support our growth drivers, we are constantly open to opportunities to bolster our business through mergers, acquisitions or partnerships. As developed markets mature, we are focused on the one hand on ways to consolidate these markets and maximise the value from them, and on the other on the new growth areas of emerging markets, in particular, large fast growing markets such as India (where we are already a leading player), Russia, China and parts of South America. We are in advanced stages of discussions with both Russian and Chinese travel providers and aim to complete at least one of these early in 2010. In addition, we are always on the look-out for smaller deals that enable us to maintain our competitive advantage.

Performance Highlights 2009
A number of acquisitions were completed, notably Gold Medal and Med Hotels in the UK, adding to our independent businesses. Progress was also made in evaluating opportunities in China and Russia.

Treasury and Finance
Prior to the merger the two components of Leisure Travel were quite different, LT being older, larger and more diversified.

The differences extend to the treasury functions in the two companies pre-merger. Edited extracts from related documents are reproduced below:

Leisure Tours AG

- **Financial Constitution**

The Financial Constitution defines the goals, principles, basic conditions as well as the tasks and responsibilities for the group-wide financial management within the Leisure Tours Group. The Financial Constitution is superior to all other financial guidelines and sets a framework for the financial management within the Leisure Tours Group. The purpose of this Financial Constitution is to ensure that all financial transactions are conducted according to the principles authorized by the management board of Leisure Tours AG.

- **Functional Financial Guidelines (FFG)**

The Functional Financial Guidelines outline the goals and principles laid down in the Financial Constitution in more detail. The tasks within financial management are governed by the Functional Financial Guidelines for:

- Cash Management
- Financial Risk Management
- Financial Risk Control
- Financing

- **FFG : Cash Management**

The main goal of Cash Management is to optimize the costs of short-term financing and the profits of short-term financial investments within the Leisure Tours Group. Cash Management is also responsible for liquidity planning up to one year, payment transactions, the concentration of liquid funds via Cash Pooling and the daily disposition. The investment of surplus / borrowing of liquid funds on the money market is executed by Financial Risk Management with the information provided by Cash Management.

- **FFG : Financial Risk Management (FRM)**

The main goal of Financial Risk Management is to control financial risks (e.g. Interest and FX Risks) and to minimize any negative impact on the Balance Sheet and the Profit and Loss Statement of Leisure Tours AG.

Deutsche Air manages the fuel hedging for Leisure Tours AG.

- **FFG : Financial Risk Control**

Financial Risk Controlling aims at measuring all financial risks and reporting them in an appropriate way. A comprehensive system of limits and lines should be developed, continuously monitored and updated.

Financial Risk Controlling should be separated from Risk Management in order to provide Risk Controlling with the opportunity to fulfil its monitoring role.

- **FFG : Financing**

Financing is the provision of sufficient funds for maintaining the business operations and for securing the future growth of the Leisure Tours Group at all times, e.g.:

- Management of banking relations (incl. negotiations of credit lines)
- Corporate Finance Activities
- Working Capital Management
- Risk (Asset and Liability) Management
- Planning and Financing of large investments (e.g. aircrafts, hotels)
- Medium- / Long-Term Financial Planning (exceeding a horizon of one year)
- Development of Financing Strategies
- Management of Loan- and other Guarantees
- Customer Protection Programmes

MONROE

- **Banking**

The Group policy is to maintain close banking relations with a selected number of banks in order to achieve equitable pricing, preferential service and sufficient access to funding. Strong emphasis is placed on relationships with banks providing a range of financing services to the Group and credit support for example BP are a key provider of both jet fuel and hedging.

• Cash Management
Monroe divisions operate a 3 stage procedure to cash flow forecasting, namely;

- Short term
- Medium term
- Strategic Plan

All Subsidiaries must report their liquidity requirements on a weekly basis using the standard documentation. Completed forms must be submitted to Group Treasury by email by 11am on Monday morning.

• Investment Management
The overall objective of Group Treasury cash and investment policy is to maximise the yield on cash investments within the Board approved guidelines, (documented in the schedule) and to ensure that the maximum of cash is held by Group Treasury for investment or repayment of group debt as appropriate.

All subsidiaries must minimise cash held and all surplus funds should be placed with Group Treasury. Any exceptions for technical reasons or other operational reasons must be agreed in advance by Group Treasury.

Deposits will be made by the business units with Group Treasury at an agreed rate the term of which should reflect the subsidiaries cash flow requirements as forecast.

• Borrowings
No borrowings are permitted without the prior sign off from the Group Treasurer, Director of Corporate Finance, or the Group Finance Director, as the entering into of a borrowing, the provision of a letter of credit or guarantee may breach Group financial covenants or other conditions. Any borrowings with a maturity greater than 6 months requires the approval of the GFD.

Under no circumstances should assets be pledged or mortgaged, covenants be entered into or financial ratios agreed as part of any borrowing facilities, without the prior written agreement of the Group Treasurer. The Group Treasurer must inform the GFD and Director of Corporate Finance prior to agreement.

• Foreign Exchange & Fuel Exposure
Exposure management is broken down into:-

- Transaction Exposure - applicable for Foreign Exchange and Fuel
- Economic Exposure - applicable for Foreign Exchange and Fuel
- Translation Exposure - applicable for Foreign Exchange only

All transactional foreign exchange, fuel and interest rate exposure should be hedged as soon as the exposure becomes known; speculative hedging is strictly prohibited. Hedging must be in accordance with the Monroe Group Plc Treasury Hedging Policy.

• Interest Rate Exposure Management
Interest risk exposures are managed and undertaken solely by Group Treasury.

The objective is to minimise the risk to the Group's interest charge and investment income caused by movements in interest rates by seeking to manage the debt and cash portfolios with an appropriate mix of fixed and floating interest rates in the short, medium and long term.

• Bonding & Guarantees (Including Letters Of Credit, Promissory Notes)
All Bonding and Guarantee requirements must be sourced through Group Treasury (unless dispensation is given). (Bonding refers to the provision of bank guarantees to regulatory authorities and other bodies in order to retain licences or membership from these bodies or to comply with local laws.)

Promissory Notes which are not to be discounted i.e. not incurring a cost may be issued by subsidiaries upon agreement with Group Treasury. Promissory Notes may be issued and discounted by beneficiaries at their cost. All Promissory Notes which are to be discounted at a cost to the subsidiary must be sourced through Group Treasury.

Detail of FX Hedging
To exemplify the policies of each party prior to the merger, some detail about FX hedging is reproduced below.

Leisure Tours AG FX Management
For the adequate presentation of its inherent risks the foreign currency position of Leisure Tours Group is divided into the following portfolios:

• Operational Business - Tour Operator
- Carrier
- FX-Exchange

• Investments and Special Transactions
• Strategic Hedging
• Active Management

Portfolio "Tour Operator"
The portfolio "Tour Operator" relates to the active management of foreign currency risks which derive from the ongoing catalogue-business of the tour operator division. The foreign currency positions are generally "short", meaning foreign currencies have to be acquired to pay invoices.

Portfolio "Carrier"
The portfolio "Carrier" manages among others those foreign currency risks which derive from the procurement of fuel per planning period. Hedging of the foreign currency demands is performed exclusively by Financial Risk Management (FRM).

Portfolio “Currency Exchange”
Leisure Tours Group is also in the business of currency exchange and offers its customers the exchange of currencies, Traveller Cheques and Traveller Cards.

Portfolio "Investments and Special Transactions"
Foreign exchange risks resulting from individual contracts are allocated to the portfolio "Investments and Special Transactions". These contracts differ in structure, maturity and amount from the ongoing day-to-day business, which is managed in the portfolios "Tour Operator" and "Carrier". The portfolio includes i.e. foreign exchange risks resulting from financing airplanes and hotels.

Portfolio “Strategic Hedging”
Strategic hedging constitutes a special kind of hedging methodology and is exclusively applied when special circumstances arise (i.e. historically low market prices).

A strategic hedge has to be authorized by the CFO, acting upon a proposal by Financial Risk Management (FRM). The design of the strategic hedge has to take into account its effects on the other portfolios.
The authorization for the execution of strategic hedges is limited to FRM.

Portfolio “Active Management”
To take advantage of market situations and to manage opportunity risks it may be necessary to deviate to a certain degree from the regular hedging strategies described above. These deviations are called active management.

Active management is performed exclusively by FRM.

Foreign exchange transactions destined for the portfolio "Active Management" have to be clearly labelled as such at the conclusion of the transaction. A rededication of transactions executed as part of Active Management to other portfolios is not permissible.

Monroe FX and Fuel Hedging Policy
Purpose
The Group Hedging Policy is designed to accommodate the commercial requirements of the business and ensure that there is minimal exposure to fluctuating exchange rates and adverse price movements in physical jet fuel markets once budget rates have been agreed.

The Group operates a rolling 12-18 month hedging programme for both fuel and foreign exchange, which results in a target level of hedging being in place 6 months prior to the commencement of the relevant season.

The *budget cycle* for winter commences in February/March, and ends in May/June, at which point Summer commences, ending in September/October.

Commercial/Geographical considerations

These vary between the divisions, but approximate to the *budget cycle*.

- Monroe (Northern Europe) look to achieve certainty over hedge rates and hence budget costs per the detailed hedger timetable below. The objective of this re timetabling is to align the cost to the business (through exchange rate fixing) with that of brochure pricing.

- Monroe (North America). The North America timeline lags that of both the UK and Northern Europe, hence the hedge process commences up to 10 months in advance of the season.

- Monroe (UK). Brochure pricing and sales commence up to 18 months in advance of the season start accumulating at 7.5% of total exposure per month up to a period of 6 months in advance of the season.