4.4.5 Risk Evaluation and Response Exercise Answer

Unit:	Unit 1 – Treasury Strategy
Module:	Module 4 – Financial risk
Date:	1 September 2016
Summary:	Answer to exercise on risk evaluation and response.

The answers from Exercise 4.2.2 are repeated here for completeness.

Answer 1

a) Given your responses to Question 2, identify five major finance/treasury risks facing LT in the medium term, with a brief one-line justification for each risk identified.

- fuel, given price volatility and significance for travel cost (own aircraft and third party).
- FX (transaction), again given potential volatility and proportion of costs exposed to FX risk, e.g. for accommodation, catering.
- liquidity, given size of seasonal swings in cashflow
- interest risk on debt and depos.
- counterparty risk on cash balances and mtm on derivatives, the latter a two-way item
- Others: pension, FX translation

b) What assumptions would you make about the extent of each risk in order to stress test business plan forecasts.

Fuel price:	20% normal; 50% abnormal: cost impact/if hedged collateral
FX:	5%; 25%: impact on costs/collateral
Liquidity:	Lower trough, delay/shortfall in recovery
Interest:	Variation 1%; 2.5%; impact on net cost / collateral
C'party:	All banks down one notch; two bank failures

c) Suggest a disaster scenario reverse stress test for LT [involving one of the five finance/treasury risks which you identified above].

- Fuel supply interruption for one/two months.

Answer 2

LT is exposed to several typical treasury risks including

- fuel price risk
- currency pre-transaction risk

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For each risk:

a) Explain how the risk arises in LT.
Fuel: significant and volatile element of travel costs.

FX pre-transaction: significant, volatile element of non-travel costs; to issue catalogue prices and not have to resort to last minute surcharges, LT needs to hedge these costs well ahead of the season.

b) How material is each type of risk for LT? Quantify and indicate the level of sensitivity, noting any assumptions made.

Fuel: Comprises around 8% of total costs, with a recent history of increasing by as much as 50%. So very significant in this low margin business. Note that the hedging of this risk gives rise to another, i.e. the potential cost of collateral calls on derivative mtm valuations.

FX: Overall, after hedging, LT 2009 a/cs state that a 5% shift in EUR and USD would impact PBT by £18.8m.[1]

In the Case section 3.5 TCAG labelled this risk Portfolio "Tour Operator". MT discussed it in terms of the budget cycle and the pre-season booking period. Section 2.0 Tour Operating Sector indicates tour operator margins of 5-10%. Taking the cost breakdown of tour operators on pages ¾, and making assumptions about non -domestic parties:

Accommodation	34% x 0.75	= 25%
Aviation	38% x 0.50	= 19%
Destinations	8% x 1.00	= 8%
		52%

So at least 50% of costs are exposed to fx volatility and margins are as low as 10% of that number, so even minor volatility can be terminal!

As for fuel, collateral calls are a potential problem.

c) Identify the key policy dimensions for the management of each of these risks within LT.

- Fuel: Policy issues include:
  - timeframe
  - instruments eg collar options
  - competitor behaviour
  - collateral call management
  - own fleet, third party carriers
  - hedge accounting

[1] This information was not in the background data and is provided for information. The case study is based on Thomas Cook plc and this data can be found on page 93 of the 2009 accounts (£8.8m re Euro, £10m re USD)

- FX: Policy issues include:
  - attitude to fx surcharges
  - target % hedge
  - local norms for catalogue lead time re. start of season
  - treatment of contracted flows
  - treatment of forecast flows
  - netting
  - instruments
  - collateral calls
  - hedge accounting impact on hedge timing