3.2.3 Influence of Earnings Volatility and Sector on Financial Leverage Exercise Answer

Unit: Unit 1 – Treasury Strategy

Module: Module 3 – Financial strategy

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Summary: Answer for exercise to see the influence of earnings volatility, other financial measures and sector on the leverage decision and financial strategy.

Bodycote plc

Expectation

Bodycote operates in the industrial sector and will probably show sales volatility in accordance with the economies where it operates. If it is global, sales will be less volatile. Depending on its fixed cost level, earnings will probably be more volatile than sales and it is likely to have suffered badly in 2009. Like most industrial companies, it is likely to have some debt but being quoted it is likely that this will be moderate.

Review

Core sales are indeed volatile with the expected large dip in 2009. Some volatility might be explained by acquisitions. Assets / Sales is approximately 1, so assets are quite high in relation to sales. Earnings are also volatile as is the operating margin. Bodycote helpfully produce a return on capital employed which is stable apart from the year 2009.

Bodycote has debt of about 10% of shareholders funds (accounting basis) which is low and about 1 turn of EBIT, or less than 1 turn of EBITDA. Interest cover is very high. Thus on all counts Bodycote has moderate levels of gearing and is conservatively financed. Disposals up until 2008 have helped reduce debt and it is possible that Bodycote is in a sector where consolidation might be happening and so financial flexibility is required to deal with unexpected events. Thus Bodycote has room to gear up.

We can conclude that Bodycote is pretty much levered as expected.

Cookson plc

Expectation

Cookson operates in the industrial sector and will probably show sales volatility in accordance with the economies where it operates. If it is global, sales will be less volatile. Depending on its fixed cost level, earnings will probably be more volatile than sales and it is likely to have suffered badly in 2009. Like most industrial companies, it is likely to have some debt but being quoted it is likely that this will be moderate.

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Review

2010 shows increased sales because of an acquisition but beofre that there is a fairly substantial volatility in sales. Assets / sales is less than 1, showing more efficiency than Bodycote. Apart from 2009, the operating margin is fairly stable at around 10% so earnings are also volatile.

Cookson has debt of around 1 turn of EBITDA and very high underlying interest cover. Free cash flow has been very stable (apart from 2009 when high cash generation followed a fall in working capital) and is about 20% of net debt. Thus on all counts Cookson has moderate levels of gearing and is conservatively financed. Cookson has been through its share of scares in the past and the sector is clearly volatile, prompting modest levels of debt. Again the sector might be in consolidation and so financial flexibility is required to deal with unexpected events.

We can conclude that Cookson is pretty much levered as expected.

Hammerson plc

Expectation

Hammerson plc operates in the property sector and features of the property sector are that rents are relatively low compared to asset prices, typically yielding less than 10%; and assets are an important part of the business model. To generate equity returns consistent with other sectors therefore it is quite normal for the business to be reasonably heavily geared and for all the financial measures to be quite tight. So we could expect interest cover to be low and gearing to be high. We would not expect much volatility in sales revenue or operating profit and stability should be a feature of the business.

Review

We can see immediately from the net rental income line that this business has very low volatility of income, which continues into the operating profit line, showing that there are few costs in running this predictable business. As profit translates to profit before tax, and other net gains and losses are brought in, we do see volatility but essentially the operating income is very stable. We are helpfully shown at the bottom some financial ratios showing that gearing is quite high in 2010 at 52 percent and interest cover is still reasonable at over two. There is very little capital expenditure in this business so essentially most rents flow straight through to profits and the cost of finance. It is interesting to note that in 2008 gearing went to 118 percent but this was clearly absorbed within the safe financial structure. Interest cover fell only to 1.7, slightly below its long-term average. It is interesting to note that currently gearing and interest cover are slightly more conservative than in previous years. In summary the financing for this business is very much as expected.

The Cardiff Property plc

Expectation

The Cardiff Property Company is not a well-known name in the property sector and is small (several orders of magnitude smaller than Hammerson), but the same considerations as for Hammerson apply. We can expect low volatility of income and of profits and expect that the business will be financed quite heavily by debt.

Review

From the small amount of information that we have, we can see the gross rental income is indeed very stable and the volatility of profits comes completely from the sale of development properties. In 2010 we see that the profit after tax is a very high proportion of revenue, as would be expected. What is surprising here is that this business has no gearing at all during the 5-year period. One can only presume that the directors do not see any suitable additional investments as it would be quite normal for a property company to be financed heavily by debt. Alternatively, Cardiff Property Company is deliberately pitched as a conservative investment for shareholders – who are satisfied with a lower return compared to that anticipated by Hammerson's shareholders, for a substantially lower level of risk.

Exercise conclusion

The purpose of this exercise was to see if there were any natural borrowers defined by their sector. It was then interesting to see if we could deduce anything about their financial strategy from the data that we had available.

While there were some exceptions, our expectations about revenue and earnings volatility were generally found to be correct. Those with the more volatile revenue and earnings, i.e. the industrial companies did not seem to be 'natural' borrowers. Generally these businesses did not have high levels of debt. The business with the highest debt was one of the property companies. Such an ability to carry high debt was not necessarily followed through as a financial strategy by all companies in the sector, as we saw with The Cardiff Property Company. This was either as a result of a deliberate financial strategy or because no suitable investments were available.

It is clear however, that sector has an enormous influence on financial strategy. The size of the assets in relation to turnover, the marketability of those assets, the volatility of revenue and operational leverage are all influences on financial strategy and each of those factors changes according to sector.

It is important as a treasurer therefore to be aware of the sector that your firm is in and what your peer group is doing in terms of financial strategy. To a large extent, decisions around credit are made before a borrower even walks through the door of the lender. Valuable lessons can be learned.

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