Case Study 1

1.3.1 Ratings Issues Exercise[1]

Unit:	Study Unit 3 – Strategic Treasury Solutions
Case:	Case study 1 – Treasury opportunities
Date:	1 September 2016
Summary:	Exercises examining why Victor has chosen a ratings target as a benchmark, and estimating and evaluating the financial implications of Victor's current rating.
Key words:	rating, benchmark, debt capacity

Another interesting thing about Victor is that it explicitly targets a rating rather than attempting to optimise WACC. This may seem unusual, and also in this activity we will consider why Victor has chosen a ratings target as a viable alternative to a WACC target for capital structure management. (Just to clarify and as we will see, Victor knows perfectly well what its cost of capital is at any point in time – otherwise how would it evaluate its investments? Victor simply prefers to *target* a rating.) Use the background case material for Victor, your text books, readings and any other resources you consider applicable.

Question 1
Discuss the rationale for targeting a rating.

Consider:
A Why might Victor prefer a ratings target to a WACC target?
B Why would Victor target an 'A' rating rather than a higher (or lower) investment grade?
C To what extent is Victor's ratings target priority consistent with the "traditional" approach of optimising its WACC?
D What are the consequences for Victor's strategy while its current rating is BBB+?

Student Notes (letters refer to questions above)
A Why target a rating and not an optimal capital structure?
A Consider the industry/market in which Victor operates and its strategy for growth.
A What are the advantages for Victor of targeting a rating, considering the organisation as a whole?
B What are the implications for Victor of a higher or lower investment grade target?
C What is the point of the WACC?
C Are WACCs and ratings correlated?
C Should treasury recommend that the corporate finance department use the WACC in its overseas investment appraisal?
C Should (can) Victor disregard WACC altogether?

[1] Post your responses to the various questions and discuss your thoughts and responses in the Case study 1 forum in light of the answer posted by fellow group members and the model answer released by the tutors You are expected to post during the Case study 1 timeline – see course site U3/Case 1 for dates.

Question 2

Analysis:

A How consistent are Victor's financials with 'A' rating criteria?

B What is Victor's debt capacity if it recovered to an 'A' rating criteria?

C What is Victor's debt capacity if it remained at a BBB+ rating?

Student Notes

A Derive the key ratios commonly used to assess credit worthiness for Victor and compare to benchmark values by ratings grade. See Unit 1, Module 3, readings '3.3.1 Towards a complete financial strategy', '3.5.1 Making yourself a good borrower'. Draw your own conclusions from this.

A Consider non-financials (business risk) and sustainability

B Estimate Victor's debt capacity within the A rating band.

C Estimate Victor's debt capacity with the BBB+ rating band.