6.1.3 Subsidiary Financing Exercise

Unit: Unit 2 – Treasury Applications

Module: Module 6 – Managing the corporate structure

Date: 1 March 2012

Summary: An exercise investigating the implications of using different methods of subsidiary financing.

Keywords: export credit funding, syndicated credit facility, intercompany loan, short term FX swaps, cross currency interest rate swap, implied cost, covenant

This exercise is based on an exam question in one of the recent MCT case study exams but extra questions have been added. While time would be limited in an exam, the problem can be analysed in greater depth at this current stage in our studies.

As newly-appointed Group Treasurer of PPP Group, you have been sent the following summary of a problem that has been developing in the 100% owned Russian subsidiary. It is now early January 2011.

The modernisation and expansion of a pulp and paper mill, costing EUR 350 million, was financed by EUR 90 million export credit funding in EUR and a EUR 260 million inter-company loan, funded from the group's EUR syndicated credit facility, and lent in Roubles. Of the EUR 90 million export credit debt only EUR 26 million is hedged locally, to contain the interest cost, which is in breach of Group Treasury Policy. For the phased draw-down of the inter-company loan, during the construction period, short-term FX swaps were used, to be rolled over on maturity, with a view to undertaking a longer-term amortising cross-currency interest rate swap to match the repayment profile on completion of the project. At the outset rouble and euro interest rates were very similar.

The project was scheduled to start in April 2010 and be completed in mid-2012, but problems with contractors and the unusually-severe weather in December 2010 led to disruption and delays in the construction work, but this is now progressing satisfactorily, if somewhat behind schedule. The majority of the pulp produced will be converted to paper in Russia, but a significant and variable proportion is exported to sister companies in Eastern European countries, Israel, Greece etc.

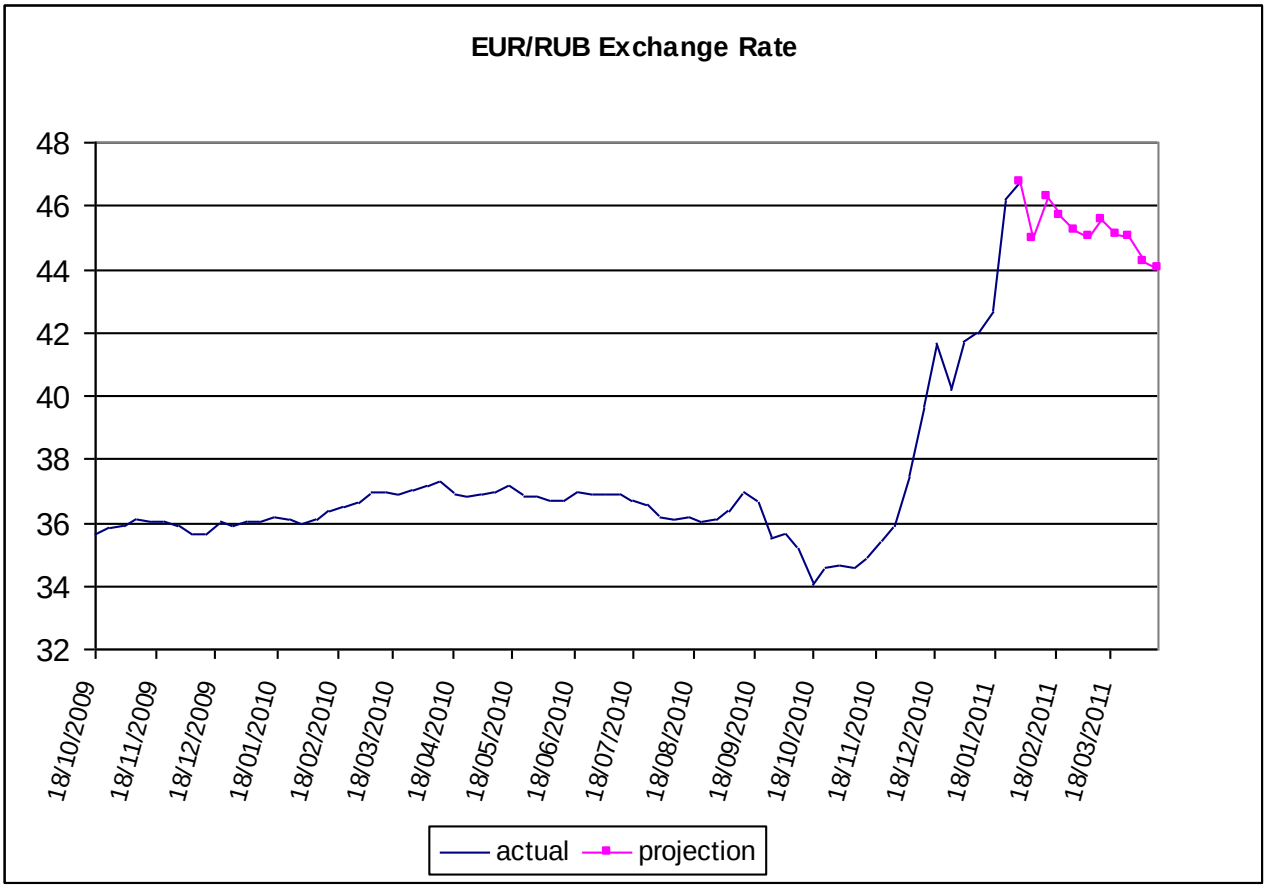
In Quarter Four 2010 the rouble came under intense pressure and the exchange rate against the rouble went from around 34 to 46 in a matter of months. You have a chart of the rouble/euro exchange rate over the relevant period. Inflation rose to around 13% and the 3 month Moscow Prime interest rate, which had crept up from 6% to 10% over the third quarter, rose sharply to 21.7%. The implied cost of borrowing via the FX swaps went from 10% to a volatile 30-55%, reflecting real market concern about the possibility of a rouble devaluation. Forward market implied yields remain high until the end of 2012 and beyond, but there is a danger that the FX swap market might close. Some of the total borrowing cost

can be capitalised to the project cost during the construction period then subsequently amortised. Meanwhile, Euro interest rates remain around 3%.

You have a table with details of the forecast covenant situation before the recent currency crisis broke, which was already a cause for concern. Note that the covenants were determined by the banks lending under the export credit facility. You also have a chart of the rouble/euro exchange rate over the relevant period (N.B. the dates have been changed for the purposes of this question).

Covenant Monitoring - PPP Russia

Euros million	Q1 2011	Q2 2011	Q3 2011	Q4 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013	Dec 2013
Interest cover										
Trailing 12m EBIT	46.9	45.0	32.6	37.3	43.3	48.7	64.4	72.3	70.7	109.5
Trailing 12m interest	30.7	28.4	28.4	32.5	34.5	35.1	34.2	32.8	31.2	23.1
Interest cover	1.53	1.58	1.15	1.15	1.26	1.39	1.88	2.20	2.27	4.74
Covenant minimum	**1.00**	**1.00**	**1.00**	**1.00**	**1.00**	**3.00**	**3.00**	**3.00**	**3.00**	**3.00**
Maximum interest	46.9	45.0	32.6	37.3	43.3	16.2	21.5	24.1	23.6	36.5
Interest under / (over) limit	16.2	16.6	4.2	4.8	8.8	(18.9)	(12.7)	(8.7)	(7.6)	13.4
Total debt to EBITDA										
Trailing 12m EBITDA	72.3	71.4	60.9	70.3	80.5	89.1	107.3	114.8	112.8	148.1
Total debt	269.1	305.8	333.3	345.7	337.3	318.6	300.0	281.4	262.7	167.3
Total debt to EBITDA	3.72	4.28	5.47	4.92	4.19	3.58	2.80	2.45	2.33	1.13
Covenant maximum	**6.00**	**6.00**	**6.00**	**6.00**	**6.00**	**3.00**	**3.00**	**3.00**	**3.00**	**3.00**
Maximum debt	433.8	428.4	365.4	421.8	483.0	267.3	321.9	344.4	338.4	444.3
Debt under / (over) limit	164.7	122.6	32.1	76.1	145.7	(51.3)	21.9	63.0	75.7	277.0
Total debt to tangible net worth										
Total debt	269.1	305.8	333.3	345.7	337.3	318.6	300.0	281.4	262.7	167.3
Tangible net worth	302.5	302.5	302.7	304.5	311.5	311.8	312.1	312.4	312.8	340.1
Total debt to tangible net worth	0.89	1.01	1.10	1.14	1.08	1.02	0.96	0.90	0.84	0.49
Covenant maximum	**1.70**	**1.70**	**1.70**	**1.70**	**1.70**	**0.90**	**0.90**	**0.90**	**0.90**	**0.70**
Maximum debt	514.3	514.3	514.6	517.7	529.6	280.6	280.9	281.2	281.5	238.1
Debt under / (over) limit	245.2	208.5	181.3	172.0	192.3	(38.0)	(19.1)	(0.2)	18.8	70.8
Assumptions										
Blended interest rate paid	11.4%	9.3%	8.5%	9.4%	10.2%	11.0%	11.4%	11.7%	11.9%	13.8%
Inter-company loan interest rate	8.00%	8.00%	8.00%	8.00%	8.00%	8.50%	9.00%	9.50%	10.00%	10.00%
EUR interest rate	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%



Question 1
Summarise the situation facing PPP Russia.

Question 2
Quantify and evaluate the scale of the forecast covenant problem as revealed in the table, review the range of possible corrective actions and make recommendations about your preferred course of action.

Question 3
What impact is the current currency problem likely to have on the various covenants and how might this affect your proposed solutions in question 1?

Question 4
How important is the management of the loan covenants of a subsidiary in a group like PPP and why? How might this particular problem have been avoided?