4.6.4 Foreign Exchange Translation Exposure Exercise Answer

Unit: Unit 1 – Treasury strategy

Module: Module 4 – Financial risk

Date: 1 September 2015

Summary: Answers to exercise in translation risk.

Answer 1

We achieve the following on consolidation:

	Playwell	Playhard Assets	Consolidate
	£m	€m	1.50
Operating Assets	90.00	100.00	156.67
Cash / (Debt)	10.00	(91.00)	(50.67)
Net Worth = Equity	100.00	9.00	106.00
EBITDA	10.00	12.00	18.00
Interest 7%	0.70	(6.37)	(3.55)
	Earnings		14.45
	Net worth = Equity		106.00
	Gearing (debt /equity)		48%
	Net debt / EBITDA		2.81
	Interest cover		5.08

The acquisition has taken Playwell from a conservative cash rich group to a moderately highly geared one. Credit ratios make it fairly but not very risky. In fact interest cover is quite high, even at the high interest rates quoted. It is likely that the lenders will insist on covenants based round Net debt / EBITDA and interest cover.

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Answer 2

	Playwell	Playhard Assets	Consolidate	Consolidate		Change
	£m	€m	1.50	1.10		
Operating Assets	90.00	100.00	156.67	180.91		15.5%
Cash / (Debt)	10.00	(91.00)	(50.67)	(72.73)		43.5%
Net Worth = Equity	100.00	9.00	106.00	108.18		
EBITDA	10.00	12.00	18.00	20.91		16.2%
Interest 7%	0.70	(6.37)	(3.55)	(5.09)		43.5%
	Earnings		14.45	15.82		9.4%
	Net worth = Equity		106.00	108.18		2.1%
	Gearing (debt /equity)		48%	67%		40.6%
	Net debt / EBITDA		2.81	3.48		23.6%
	Interest cover		5.08	4.11		-19.1%

What we see after the move in exchange rates is dramatic. The financial controller is happy because he only sees a (favourable) movement of £2.18 million or 2.1% in his accounts but the treasurer is in all kinds of trouble. Although the group is more profitable as a result of the change in exchange rate, all his credit metrics are worse and some significantly so. Gearing is up 40%, net debt / EBITDA up by 24% and interest cover down by 19%. Those movements are significant enough to cause possible breaches on financial covenants or as a good few notches down in credit rating.

The financing method chosen by Playwell is a very common one, used to avoid the foreign exchange differences that might be possible. And in any case, any such differences may be taken to reserves under current accounting standards. To that extent, this type of financing is almost encouraged under these rules. The financing method is also quite intuitive, and financing euro assets with euro debt is understandable. However, it has proved in this case to be really quite a dangerous approach to financing.

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