1.2.3 The Corporate Context of Treasury Exercise Answer

Unit: Unit 1 – Treasury Strategy

Module: Module 1 – Corporate strategy

Date: 1 September 2014

Summary: An analysis of the Report and Accounts for Yule Catto to review the corporate strategy and the context of treasury within that strategy.

YULE CATTO CASE ANSWER

Note that the language of the chemicals industry doesn't help the lay reader and Yule Catto makes little effort to clearly explain its business or the terminology it uses in its annual report. Their website is a little more helpful.

You should also note that because the annual report is silent on some particular issues, for example, Yule Catto's preferred mix of fixed and floating debt, it does not mean that it does not have a policy on this issue. Rather that it does not wish to disclose it either because it believes it is commercially sensitive; or because it does not want to be a hostage to fortune; or for some other reason.

Yule Catto's annual report, in common with many annual reports, simply ticks the boxes and discloses the minimum. Moreover, the information it chooses to disclose and emphasise changes from one year to the next. One lesson you should take home from this exercise is that annual reports are an incomplete source of information.

Overall business objective:

- Is there any mention of an overall business objective in Yule Catto's annual report? On page 26, in the Corporate Governance Report, we see that the Main Board recognises that it is responsible for setting long-term objectives and the strategies (see below) to achieve them, but says no more.
- The cornerstone of corporate finance theory is the maximisation of shareholder value, yet this appears only within Note 21 (Financial Instruments) on page 61, "The Group manages its capital… while maximising the return to stakeholders through the optimisation of the debt and equity balance. However, is this just lip service? On the inside cover of the annual report, Yule Catto trumpets that it has, "…achieved a further substantial reduction in its debt…" And, in the Financial Review on page 13, Yule Catto states that Net debt to EBITDA is the Group's key leverage metric – under 1.0 times at the end of 2010. It is difficult to see how these statements are compatible with the value maximisation statement in Note 21.
- Yule Catto has not published group "achievement" targets such as sales growth. It rarely mentions its market position (a key success factor in the fragmented speciality chemicals industry where there has been significant consolidation with companies specialising in niche areas with few direct competitors. It is vital to be #1 or #2 for success – note that Appendix A in Yule Catto's interim presentation, dated August 2011, does provide this

data on pages 41 to 43.), although in its Key Themes summary in the Full Year Results Presentation (slide 4), it talks about "market leadership positions."

- There is a little on Key Performance Indicators in the Directors' Report (page 25), but, in respect of financial matters, we don't know what the targets are.
- The Directors' Remuneration Report (page 30) is a little more illuminating. The two executive directors' bonuses are based on PBT growth and those of senior managers are based on profit, cash flow, working capital and safety and environmental (critical in the chemical industry) targets, although the targets are not disclosed. So, clearly financial performance is a key deliverable. Moreover, the LTIP options only vest if total shareholder return (dividends plus capital growth in the share price) exceeds RPI and the FTSE250 total return by agreed percentages. This implies a direct link to shareholder value, but if the chemical sector does well compared to the FTSE250 total return (which could be driven totally by sentiment or indeed unexpected demand for products or competitor failure), then the LTIP options could vest irrespective of management performance. An LTIP benchmarked against sector peers might seem more appropriate. However, there is very little direct comparison between specialty chemical companies in the FTSE 250. That said, the 2008 awards have vested in full despite reduced or no dividend payments and a share price which has tracked the FTSE 250 for the period under review (3 years to end 2010) (see the table in the Directors' Report on page 31)

Business policy/corporate strategy:

- Again, Yule Catto's annual report is sadly wanting in this area.
- Polymers: In the Chairman's statement on page 4, Yule Catto states, "Our strategy in Polymers remains focused on geographical expansion around existing business hubs, further increasing our presence in emerging markets, particularly in Asia, and in developing market sectors where our technology, new product development and manufacturing capabilities give us a real competitive advantage." See the examples in the CEO's Review, "Innovation in Asia" on page 11.
- The transformational acquisition of PolymerLatex is somewhat at odds with the above statement with 70% of its turnover in Europe and only 16% in Asia (slide 29 of the Full Year Results Presentation), although the emerging markets strategy appears to be intact – see Outlook on page 5 of the Chairman's Statement.
- In the CEO's Overview on page 6, the Polymers' strategy is to, "…invest in new products and [expand] into attractive emerging markets." (If you look on Yule Catto's website you will see that their "…approach is to work actively with our customers to ensure we understand their requirements and deliver innovation and performance to their products." In the 2007 Annual Report Yule Catto was touting itself as a "Trusted Partner".)
- It is clear from Slide 4 of the Full Year Results Presentation that Polymers is now the core division for the future. In their summary (slide 25) we see that Yule Catto is "focused on growth driven by Polymers."
- Slide 19 of the Full Year Results Presentation highlights future profit drivers as "Capacity increases… in Asia and the developing world"…"and being paid for the value we add."
- Pharma: In the CEO's report on page 10, Yule Catto talk about "Our strategy of selective dossier development…" and "the strategy of registration of other marketing authorisations of an enlarged range of generic products…" Other than that, nothing. It is very difficult to detect any real strategy from the annual report and Pharma now appears

increasingly marginalised with the acquisition of PolymerLatex. The CEO talks about "continued productivity and process improvements", but these are hardly strategy points in the specialty chemicals world. It would be different in the commodity chemicals sector where success is all about plant utilisation and cost minimisation. When you produce an homogeneous product, the most successful companies tend to be those who are the lowest cost producers as customers (generally specialty chemical firms) buy on price and security of supply. (However, if you visit Yule Catto's website, you will see that their target is to file six 'drug master files' in the major generic markets every year.)

- Impact: No strategy points, other than a mention that the only remaining business is one from an original five, the other four of which were offloaded in 2008. Conclusion? Not core, although increasingly profitable. Note that in Slide 24 of the Full Year Results Presentation, we are told of "Several projects in the pipeline to further increase profitability" so this business is still being developed.
- The Corporate Social Responsibility Report (pages 14 to 21 of the annual report) which covers safety and environmental issues is extensive. This is common in the chemicals industry and is the only area where targets are disclosed and reported against. Sadly, it is of little use in understanding the dynamics of the business.

Financial policy and objectives:

- As we have already noted, in Note 21, Financial Instruments, on page 61, we are told that, "The Group manages its capital… while maximising the return to stakeholders through the optimisation of the debt and equity balance." However, it is far from clear what Yule Catto means as there has been a strong emphasis on debt reduction – see the 2010 Highlights on slide 5 of the Full Year Results Presentation which cites net debt to EBITDA of 0.9x and a "significant reduction in net debt". This is emphasised in the Financial Review on page 13 of the Annual Report where we are told that Net Debt to EBITDA is the Group's key leverage target. Nevertheless, there is no comment about target levels or covenants.
- Yule Catto has partially refinanced at the year end to accommodate the PolymerLatex acquisition. It has not provided any pro-forma data in any of its financial statements (even in the Full Year Results Presentation where it talks about the future with PolymerLatex) for the new combined entity even though many of the metrics are likely to change significantly. There is likely to be a significant increase in debt as the rights issue raised only £219m of the €443m acquisition price. Historic data for Polymer Latex was provided in Yule Catto's press release of December 13, 2010. There are some superficial comments on liquidity in the Principal Risks and Uncertainties section of the Directors' Report on page 25. The Yule Catto 2011 Interim Presentation is more illuminating.
- Dividends were re-commenced in 2010 in line with comments at the time of the PolymerLatex acquisition (slide 5 of the Full Year Results Presentation) but no further comment. However, in the press release announcing the acquisition of Polymer Latex we are told, "Following completion of the Acquisition and Rights Issue, the Board intends to pursue a progressive dividend policy. This will reflect the effect of the anticipated synergies and the longer term growth profile of the Group, while also taking into account the organic growth opportunities in which the Group expects to invest, in particular in emerging markets. All future dividend payments will be subject to the Company having sufficient distributable reserves and profits available for the purpose and will take into

account the Group's cash flows, debt repayments and the need to maintain an appropriate level of dividend cover." What this actually means is anyone's guess.

- We are told in the Financial Review on page 12 that "Control of working capital is a core focus of the business management." Another platitude.
- Note that Yule Catto uses a three column presentation style for their financial results. This approach is increasingly common and used where one off items might distort underlying trends. This should help analysts (and MCT students) understand the real business. Hedges which do not qualify for hedge accounting can also be slotted into this format. These columns comprise:
    - Underlying performance
    - Adjustments
    - IFRS

Treasury Policy and Organisation:

Unless specified, the following information is set out in Note 21, Financial instruments, of the Annual Report on pages 61-64.

- According to the Directors' Report on page 23, "Details of the Group's use of financial instruments and its financial risk management objectives and policies…" is set out in Note 21. Whilst the hedging of transaction exposures is clearest (although not entirely specific), most other areas are opaque at best.
- Yule Catto has a treasury function which operates procedures designed to reduce or eliminate financial risk and to ensure that funds are available for current and future needs. Its treasury policies are approved by the Main Board and it is stated that "the use of financial instruments is strictly controlled." We are specifically told that the Group's policy is "that no trading in financial instruments shall be undertaken." However, that is all we know about the treasury organisation.
- Yule Catto hedges all foreign currency transaction exposures at the point of confirmed order using FX forwards, but the company is (naturally?) silent on how such a hedging policy integrates with its pricing policy. All exposures on monetary assets and liabilities are hedged if practicable. However, looking at FX exposure, sales to the UK are £76.6m and sales originated in the UK are £160.1 million. They are very susceptible to a strengthening in sterling on this economic exposure. They are also susceptible on upstream dividends for the same reason and also on sterling liabilities, such as debt and the deficit in the pension scheme. This type of exposure is just not mentioned at all in the report.
- Note that options are permitted (Note 2, Significant Accounting Policies, Derivative Financial Instruments, on page 43) although they do not appear to be used.
- Overseas net assets are hedged using currency borrowings, FX forwards and currency swaps.
- There is no hedging of profit translation exposures.
- Yule Catto achieves the "desired interest profile" (whatever this means) by borrowing at fixed or floating rates and using interest rate swaps. Note that the floating proportion of gross debt at the end of 2010 was 60%, up from 19% in 2009. On a net basis, however, £40m out of net debt of £63.4m is fixed, or 63%. So actually 37% of net debt is floating.
- Hedge accounting is used other than for cross currency and interest rate swaps, although Yule Catto maintains they are "fully effective at eliminating the risks they address." Note however that the P&L impact is included within Note 3, Special Items, on

page 46 in accordance with the policy set out in Note 2, Significant Accounting Policies, on page 44. Special items are excluded from Yule Catto's preferred Underlying Performance EBITDA measure.

- "Volatility in raw material prices and energy prices…" is identified as a principal risk on page 25 of the Report of the directors in the Annual Report, yet merits no further disclosure other than in the Outlook section of the Chairman's statement on page 5 of the Annual Report, which states that both Yule Catto and PolymerLatex have been successful in passing through raw material price increases in recent years. Slide 23 of the presentation to shareholders shows key raw material prices for the last 10 years.
- Note that Yule Catto has also used FX forwards to partially hedge the €443m acquisition cost of PolymerLatex.

Organisation Structure:
Unless specified, the following information is set out in the Annual Report, Corporate Governance on page 26

- Main Board with half the board members being independent. (Note that this is not the case as at the date of the Annual Report, but is being pursued as a result of entry into the FTSE250.) There are also Audit, Remuneration and Nomination committees.
- Key powers are reserved to the Main Board. The setting of long-term objectives, strategy to achieve objectives, setting policy on safety, health and the environment, recruitment and employment, risk management and treasury, plus capital raising, financial commitments, capex, acquisitions, disposals and litigation, subject to materiality thresholds.
- The responsibility for the business plan (period not specified) and annual budget rests with the CEO. Approved by Main Board.
- CEO runs the business via an Executive Committee which meets monthly comprising divisional CEOs, FD, the deputy FD, the Company Secretary and the Director of Group Human Resources. The minutes are sent to the Main Board Chairman and all Board members receive monthly reports from the CEO and FD.
- 3 divisions — Polymers, Pharma & Impact. (Annual Report. CEO's Report, pages 6-10 and Note 4, Segmental Analysis, page 47)