ACT LEADING TREASURY PROFESSIONALS

The Association of Corporate Treasurers

MCT ADVANCED DIPLOMA GENERAL EXAMINATION AND SOLUTIONS

Friday 09 October 2015   09.30 – 13.00

Instructions:

Answer **EIGHT COMPULSORY** questions.

Time allowed: **3 hours + 30 minutes reading time.**

During the reading time you may annotate the examination paper but you may not write in your answer booklet or use your calculator.

- Enter your student number on the answer booklet: **do NOT write your name**
- You must write in blue or black ink and ensure your handwriting is legible.
- Enter the order in which questions are answered in the box provided on the front of the answer booklet.
- Ensure that all additional submissions (if applicable) are attached to the answer booklet by the tag provided and write your student number on all items to be marked.

QUESTION 1

You have been provided with the following information on 5 companies, all of which have Net Debt / EBITDA ratios of 3.0 times:

Company	Sector	Sales (EUR bn)	Long Term Credit Rating
1	Healthcare	42.2	A-
2	General retailer	19.3	BBB+
3	Building materials	19.1	BBB
4	Media and entertainment	1.1	BBB-
5	Paper and forestry	9.9	BB+

Required:

a) Discuss the likely reasons for the different credit ratings, using the five companies to illustrate your answer.

(5 marks)

Fifteen years ago, when a triple-A rating was often regarded as the ultimate indicator of sound financial management, the average credit rating for bonds in issue was A/AA, whereas the equivalent average rating is currently BB. The volume of bonds issued has increased by 70% since 2007 and the majority of new issues carry ratings below BBB.

Required:

b) Discuss what the various reasons might be for such a major shift in the distribution of ratings, considering both the macro-economic environment and likely changes in both corporate and investor perspectives.

(6 marks)

(Total 11 marks)

QUESTION 2

Today corporates are carrying unprecedented levels of cash on their balance sheets and it has been argued that, since 2008, cash management has become an even bigger priority for corporates than ever before.

Required:

a) Review the main areas the Treasurer should consider in relation to strategic cash management.

(4 marks)

b) Explain why corporates may be holding unprecedented levels of cash on their balance sheets. State whether you think this is justified.

(5 marks)

(Total 9 marks)

QUESTION 3

FBS Ltd (Financial Business Services) is a private company: a leading specialist in providing intelligent technology-based solutions for complex administration tasks in the financial, public and other regulated sectors.

It originated in the spin-off of a major bank's administration and related services department in 2010 and the £550m price was financed by private equity and bank loans, including a payment in kind (PIK) facility.

The company is planning to seek a listing on the London Stock Exchange within the next five years or so. Summary financials are given in Table 1.

Company debt consists of the following:

	Amount	nominal rate	maturity
Secured bank loan	416.5m	LIBOR+3.2%	2018-20
Secured bank loan	113.7m	5.25-8.5%	2016-20
Secured PIK facility	122.3m	LIBOR+9.5%	2025
Total secured bank loans	652.5m		
(Unamortised financing costs	(9.4m)		---
Preference shares classified as debt	174.9m	8%	---
Non-secured third-party loans	65.0m	8%	2021-23
Leasing	1.3m		
Total	884.3m		

The interest rate on the PIK facility increases to LIBOR+12.5% from 2020 onwards. The bank facilities require the company to comply with certain tight covenants which, among other conditions, place limits on capital expenditure, the maintenance of a minimum ratio of EBITDA/Net Interest Payable and a maximum ratio of Net Debt/EBITDA, and a requirement for Operating Cash Flow to be no less than the Cash Cost of Funding the bank debt, all of which have been met to date.

The management of FBS recognises two close peer companies, both quoted and much bigger than FBS, one British and one Canadian. Selected data on the companies are given in Table 2.

Table 1

FBS Ltd - Summary Financial Statements

Income Statement

March	2014 GBP mill.	2015 GBP mill.
Sales Revenue	**242.1**	**266.5**
(Cost of Materials, Other External Purchases)	(78.6)	(88.8)
Value Added	**163.6**	**177.7**
(Personnel Costs)	(88.2)	(96.6)
EBITDA (before Exceps. Deprn, & all Amortisation)	**75.4**	**81.1**
(Depreciation & Impairment of Tangible Assets)	(4.0)	(3.5)
(Amortisation & Impairment of Intangibles)	(31.6)	(34.4)
Exceptionals etc. +/-	(11.1)	(11.5)
Operating Profit	**28.7**	**31.7**
Interest Received	1.2	1.0
(Gross Interest Paid)	(76.0)	(67.9)
Profit before Tax	**(46.1)**	**(35.2)**
(Tax charge)	8.5	7.1
Extraordinaries, Discontinued Operations etc	8.8	9.7
(Dividends)	-	-
Retained Profit for Year	**(28.8)**	**(18.4)**

Balance Sheet

Goodwill	396.2	354.8
Softwarte & Other Intangibles	301.9	256.9
Property, Land & Buildings & Capital Work	8.6	8.3
Plant, Equipment & Vehicles - net	3.0	2.5
Financial Investments, Tax & Pension Assets & Deriv.	6.1	15.5
Total Fixed Assets	**715.8**	**638.0**
Trade and Other Receivables	70.9	55.8
Cash and Short-term Investments	46.8	57.8
Tax Assets, Derivatives, Assets for Sale & Other	-	87.5
Total Current Assets	**117.7**	**201.1**
Total Assets	**833.5**	**839.1**
Short-term Debt	20.8	29.8
Trade and Other Payables	38.8	39.0
Provisions, Derivatives & Other Current Liabilities	2.2	21.2
Total Current Liabilities	**61.8**	**90.0**
Medium & Long-term Debt	843.7	854.4
Tax, Pension & Other Long-term Provisions	33.8	23.6
Total Non-current Liabilities	**877.5**	**878.0**
Issued Share Capital	5.0	5.0
Share Premium Account, Treasury Shares	3.5	3.5
Other Reserves	(0.7)	(3.4)
Revenue Reserves	(113.7)	(134.0)
Total Shareholders' Funds	**(105.9)**	**(128.9)**

Cash Flow Summary

Operating Profit	28.4	31.4
Tangible Asset Depreciation	4.0	3.5
Other Non-cash & Exceptional Items	37.4	52.2
(Increase) / Decrease in Net Working Assets	(7.2)	10.7
(Tax Paid)		(5.8)
Cash from Operations	**62.6**	**92.0**
Net Capital Expenditure	(2.5)	(3.0)
(Net Interest Paid)	(37.6)	(31.2)
Cash Flow before Acquisitions & Funding	**22.5**	**57.8**
(Acquisition of Businesses & Software)	(17.0)	(20.2)
Increase in Debt	-	-
Repayment of Debt	(5.4)	(26.6)
(Increase) / Decrease in Cash	-	(11.0)
Net Financing Cash Flow	**(22.5)**	**(57.8)**

Table 2

FBS Comparables	PerUK plc	Ozco Ltd
	GBP m.	CAD m.
Market capitalisation	8,470	6,083
Net Debt	3,214	2,405
Revenues	4,378	1,868
EBIT	422	327
EBITDA	649	455
Beta	0.97	1.04
Volatility %	20	17

Required:

a) **Estimate the Enterprise Value of the company as at March 2018, based on the latest available financial data and using both multiples and sustainable cash flow methods. EBITDA is expected to grow at around 5% per annum for the next three years.**

(12 marks)

b) **Summarise the current level of indebtedness and present your assessment of what might be an appropriate level of gearing for the company post-listing using your 2015 valuation for illustration and quantification. Use appropriate credit metrics and arguments to quantify and support your answer.**

(5 marks)

c) **Quantify the impact on interest cover of your recommended levels of debt and interest.**

(1 mark)

d) **State your arguments as to whether any re-financing of the company's existing debt would be needed either before or after the Stock Market listing and, if so, suggest an appropriate mix of instruments and sources.**

(4 marks)

(Total 22 marks)

QUESTION 4

Through their key role in integrated risk assessment and risk management, corporate treasurers are increasingly involved in the oversight of overseas operations. This is at a time when corporates face considerable challenges in expanding globally, particular into developing markets. A recent annual "Global Complexity Index" survey listed the UK as one of the easiest markets in which to operate with Argentina as the most difficult. The 26 most difficult countries were concentrated in Central and South America, South and East Asia, and Eastern Europe/Western Asia.

Required:

Identify four major topics of complexity for treasury and evaluate possible risk-management solutions for each of them, bearing in mind the problem regions listed above.

(8 marks)

QUESTION 5

Your German-based company, a leveraged management buyout resulting from the break-up of a UK conglomerate, exports 50% of output to operating units in the USA, France and the UK. Growth is flat.

A strategic decision has been taken to focus on high growth emerging markets. The expectation is that up to half of new operations will be joint ventures with existing manufacturing operations, given that early e.p.s. growth is a priority. Over the next five years new emerging market operations are planned to increase current revenue by 50%.

The core product, representing typically 40% of final product cost, is exported from Germany. A further 35% is added at subsidiary/JV level - 15% of the 35% is either local or imported raw materials.

The policy for EUR currency risk management now is to hedge transaction risk on exports when contracted and to hedge net investment risk as far as possible by borrowing in USD and GBP. Currencies in the new emerging markets will be much more volatile and subject to major shocks.

Required:

Explain how you would plan to manage currency risk arising from the new operations in emerging markets.

(13 marks)

QUESTION 6

Your relatively new and fast growing company is considering the acquisition of a long established and listed smaller competitor. The target company has been in slow decline for some years and has recently experienced some setbacks which left it vulnerable to takeover.

The prospect company has a closed defined benefit (DB) pension scheme, with 50% of members still active. The most recent actuarial valuation showed liabilities of £500m, and a deficit of £100m.

The composition of assets is:

Equities	50%
Government Securities	25%
Corporate Bonds	15%
Real Estate	10%
	100%

There is an agreement with the regulator to pay down the deficit of £100m over 10 years.

The acquisition negotiations, if they go ahead, will include discussions with the trustees of the prospect's DB scheme in order to acquire preferred person status for your company as bidder.

As part of the acquisition due diligence process your Finance Director needs to decide what to do about the DB scheme and asks for your advice.

Your company has a defined contribution (DC) pension scheme and no experience of managing a DB scheme.

Required:

a) List three alternatives for dealing with the inherited DB pension scheme.

(2 marks)

b) For each alternative explain the implications for the company.

(8 marks)

c) Explain which alternative you would recommend and justify your choice.

(3 marks)

(Total 13 marks)

QUESTION 7

Tax revenues forfeited by governments in some developed countries as a result of interest deductibility by non-financial firms have dropped very significantly between 2007 and 2013 (Economist, 16 May 2015) due to reduction in interest rates, eg from 0.9% of GDP to 0.4% of GDP. The expectation is that this low level may continue for at least the medium term.

Economists who argue that the tax shield on corporate debt distorts economic activity believe that these are opportune conditions for abolishing deductibility. The case for reducing debt tax relief is that cheap debt encourages leverage which inevitably leads to crises. Removing debt relief would dampen economic growth – but might increase financial stability.

Countries which have already done this for corporate debt, have usually switched the tax relief benefits to equity, rendering the change tax-revenue-neutral. The tax relief benefits to equity holders might be on the initial investment via income tax relief, on future dividends or on disposal capital gains.

Required:

Identify and explain the implication for corporate funding in the UK if the Government were to:

a) remove tax relief on corporate debt **(9 marks)**

b)remove tax relief on corporate debt and transfer the value of the relief to equity

(5 marks)

(Total 14 marks)

QUESTION 8

You have been hired by a firm of financial consultants because of your experience in corporate treasury, a market sector which the firm wishes to penetrate but in which it currently lacks expertise. The firm wishes to explore the potential for helping its corporate clients to outsource elements of their treasury functions and has asked you to help target specific corporate clients.

Required:

Identify and explain the circumstances which would make outsourcing treasury operations an attractive strategy for a corporate.

(10 marks)

ADVANCED DIPLOMA

GENERAL EXAMINATION - NOTE FORM ANSWERS

OCTOBER 2015

Question 1 **[19.8 mins, 11 marks]**

Q1.a. **(9 mins, 5 marks)**

[Marking scheme: ⅓ mark for each good point].

Answer should point out that ratings are a risk measure on probability of default, with two broad dimensions of contributing risk, namely business risk, or volatility of earnings and financial risk, measured by leverage in some form.

- Size - not the most important, but largest has highest rating, smallest has second lowest rating
- Sector economic and financial characteristics, and related risks, (most important factor) (Some illustrative examples of financial, economic and risk characteristics of each sector required here) Probably 1 to 5 increasing risk, with cyclicality very important.
- Company-specific characteristics and risks. (Only possible to give general examples here since company identities not known e.g. strategy, management track record.).
- Liquidity – does not necessarily correlate with Debt/EBITDA measure of gearing. Asset security – relatively minor influence, with no obvious differentials.

Q1.b **(10.8 mins, 6 marks)**

[Marking scheme: ⅓ mark for each good point].

AAA rating was arguably not the ultimate indicator of sound financial management – it did indicate a very safe investment for bondholders/lenders. It did not reflect the ideal capital structure for maximising shareholder returns and value – loss of "theoretical" tax-shield value of higher debt levels. This was not so well understood or accepted years ago, but much more so now –among investors and company managements. More companies would now target a chosen rating, often in line with sector peers and in line with perceived risks and company attitude to risk.

Recent economic/financial environment has made it much more difficult to achieve higher ratings. 8 In addition bank debt availability has been drastically reduced since the financial crisis, so more companies of all sizes have turned to alternative sources of debt including bonds, especially among smaller, less credit-worthy companies who would not previously have gone that route. So the statistic could simply reflect changing volumes rather than a fundamental downshift in issuer credit quality. Diversification of debt sources also a much bigger issue than previously – counter-party risks on banks and other providers of debt finance.

The difference between investment-grade and non-investment-grade credits (at BBB/BB) arguably used to be seen as a much more step-change increase in riskiness rather than one stage in a continuum of risk. This partly as a result of the investment rules which prevented many funds from holding sub -investment-grade bonds, which factor does still hold.

The low interest-rate regime since 2008 has also led to a search for yield by investors despite the higher risks. So-called junk bonds are now just as likely to be referred to as high-yield bonds. So, as this market has expanded from the issuer side demand has also grown from the investor side.

Question 2 **[16.2 mins, 9 marks]**

Question 2.a. **(7.2 mins, 4 marks)**

[Marking scheme: ⅓ mark for each good point].

<u>Managing the generation of cash – main strategic considerations.</u>

1. Working capital and supply chain management.
2. Sharing of capital, research and software investments with suppliers/customers.
3. Improved payment systems, new vehicles and counter-parties.
4. Cash forecasting and planning.
5. Cash collection and pooling.
6. Cash remittance and more efficient corporate structures.
7. Wider, Continuing search for diversified investment vehicles, diversification of counter-party risk
8. Corporate policy on investment criteria and counter-party risk.
9. Security, liquidity and yield. (SLY)

Question 2.b. **(9.0 mins, 5 marks)**

[Marking scheme: ⅓ mark for each good point].

1. Liquidity in the form of cash rather than un-drawn debt facilities is the best buffer against risk

2. Continuing economic uncertainty/weakness e.g.
3. Europe, US, China, developing countries.
4. Continuing political risk e.g.
5. Greece, China
6. Perceived reduced availability and more onerous terms of bank finance
7. Early full drawdown of bond finance can increase cash balances front-end.
8. Low cost of debt means less holding cost of debt-funded cash.
9. Delayed/postponed capital investment programmes, given the above risks
10. Less confidence in optimal capital structure model based on debt or lower optimal gearing targets 11
12. Lower interest and tax levels reduce the tax shelter benefits of debt
13. Trapped cash and
14. Globally fragmented cash is a bigger factor given wider international operations/structures.
15 If business is riskier now than ever before, standard corporate finance approach would say that leverage should be lower.

Unprecedented high levels probably no longer justified on purely financial and risk ground.

Question 3 **[39.6 mins, 22 marks]**

Q3.a. **(21.6 mins, 12 marks)**

[Marking scheme: ⅓ mark for each correct calculation, logical step or good judgement].

<u>EBITDA multiple.</u>

2015 figure for EBITDA of 81.1m was 7.4% up on 2014, with future expected growth of 5%p.a. so 2015 does not look out of line. So compound 81.1m at 5% for three years = 93.88, say 94m.

A conservative estimate of an appropriate EV multiple now might be 12 2 times EBITDA but much larger 3 comparables are on 4 18, ((8,470+3,214) / 649 and ((6,083+2,405) / 455) 5 so use 15 6 times as well to cover the likely range.

Company was sold 5 years ago for 550m (less than 7 times EBITDA) as a strategic disposal by a bank to a private equity buyer. If 5% growth has been typical of last few years current value would be around 702m which is only 8.66 x

EBITDA. If EBITDA has doubled since 2010 then the multiple at the time would have been around 13.8.

12x = EV of 1,128
15x = EV of 1,410
18x = EV of 1,692 – looks too high

As a check; Using EV/ Revenues from comparators of 2.67 and 4.55 and, allowing for 15.8% compound sales growth, revenues 2018 = 266.5 x 1.158 = 308.6.

Gives EV of 824m to 1,404m, average say 1,114m.

<u>Sustainable Cash Flow.</u>

Using actual cash-flows for 2014 and 2015 to estimate sustainable cash flow;
Cash from operations, before tax and working capital = 69.8 and 87.1, average 78.5**. (Do not add back depreciation and amortisation to EBITDA)**
Average w.c % sales = about 10% so allow for "normal" working capital increase of 5% = 10% x 266.5 x 5% = 1m.
Allow for replacement capex at, say, 110% of depreciation = 3.5 x 1.1 = say 4m.
Allow for tax **(on operating profit not on EBITDA)** at 20% = 8.3m.tax
Operating profit before exceptionals = 39.8 and 43.2, average 41.5m.

Estimate of sustainable cash flow at 2015 = 78.5 – 1 – 4 – 8.3 = 65.2m
Estimate for 2019 (3 years growth plus 1 for perpetuity calculation, at 5% p.a.) = 79.25m, say 80m

Capital structure is highly leveraged and will change on listing so don't do a detailed WACC calculation. For "correct" valuation use a "typical" after-tax WACC of, say, 7% for a smallish company "in an average beta risk sector, less inflationary growth of between 0.5% and 1%.

EV = 80/6.5%=1,230m to 80/6%=1,333m.

Conclusion; EV between 1,100m and 1,400m, best estimate 1,200m.

Q3.b. (9.0 mins, 5 marks)

[Marking scheme: ⅓ mark for each good point or calculation].

Note current EV = 1,200 discounted 3 years =1,200/1.05^3 = 1,036
Net Debt = 29.8 + 854.4 - 57.8 = 826.4m (884.2m gross debt)
Net Debt / current EBITDA = 826.4 / 81.1 = 10.2x
Net Debt % EV (2015) = 826.4 / 1,036 = 80%
EBITDA / Interest paid = 81.1/67.9 = 1.19x
EBIT / Interest = 31.7/67.9 = 0.47x

This is a typical private equity, highly-leveraged structure, as follows;

Bank loans plus leasing = 531.5m less cash = 473.7	5.84 x EBITDA
PIK facility plus third-party loans (junior debt) = 187.3m	2.31 x EBITDA
Preference shares = 174.9	2.16 x EBITDA
Total = 835.9 (excl. prep shares + unamortised finance costs)	10.3 x EBITDA

Using 1,036m as the estimated current (2015) EV;

Bank loans plus leasing = 531.5m less cash = 473.7	45.7% EV
PIK facility plus third-party loans (junior debt) = 187.3m	18.1% EV
Preference shares = 174.9m	16.9% EV
Total gross debt = 835.9m (as above)	80.7% EV
Value of equity now = 1,036-835.9 = 200.1m	19.3% EV

NB. Comparables average 5.1 times EBITDA
NB Comparables average 27.9% debt/EV

A "more normal" maximum level of net debt might be 5 times EBITDA (comparables average 5.1 times) i.e. 81.1 X 5 = 405.5m at 2015, a little less than the current senior bank debt.

This would represent 39.1% of the current estimate of EV – high enough (comparables average 27.9% Net Debt % EV).

Q3.c. (1.8 mins, 1 marks)

[Marking scheme: ⅓ mark for each good point or calculation].

With lower debt levels interest rates might be nearer 4% than the current 7.7%.
On debt of 405.5m gross interest would be 16.2m, net 15.2m.
EBITDA cover (pre-exceptionals) currently would be 81.1/16.2 = 5.01x – very good.
EBITDA cover post exceptionals would be (81.1-11.5)/16.2 = 4.30 – still very good. EBIT cover pre-exceptionals would be (31.7+11.5)/16.2 = 2.67 – acceptable.
EBIT cover post exceptionals would be 31.7/16.2 = 1.96 – just about acceptable.
(Comparables average 3.34 EBIT / Interest)

Q3.d. (7.2 mins, 4 marks)

[Marking scheme: ⅓ mark for each good point].

Don't think of re-financing the equity and quasi-equity – not asked for and the IPO proceeds from the sale of shares on listing would be largely used to redeem the most expensive debt and quasi-equity. With 8% p.a. accrual the quasi-equity might amount to 456m [(122.3 + 174.9 + 65.0) x 1.08] by 2018

Suppose then we have an IPO for 60% of the estimated EV of 1,200, i.e. 720m, so the quasi equity can easily be repaid from the IPO proceeds, – so well “covered”

After this re-financing there would be surplus proceeds of 720-456 = 264m. This would be available to repay part of the senior debt, currently 530.2m.

The core bank debt has maturities of 2016-2020 so would have to be, at least partially, re-financed before listing, some of it ASAP. It also has (very likely) quite restrictive covenants and, in part, high interest rates which are very likely escalate over time to LIBOR plus 8.5%.

Ideally a note issue, senior and secured, given the still high level of gearing, but with more relaxed covenants than the bank debt, would take out the existing senior debt of 530.2m, possibly at a mix of fixed and floating rates. A five-year facility would extend the maturity to 2021, beyond the intended listing date. It would also establish a public debt investor profile prior to the listing and possible subsequent further re-financing. A revolving credit facility would also be useful to allow for expected future growth, general enhanced liquidity and extra balance sheet capacity, say an extra 10% of existing capital i.e. about 80m.

Question 4 [14.4 mins, 8 marks]

[Marking scheme: for each good problem area identified (4 max) 3 x ⅓ marks for each aspect discussed and 3 x ⅓ marks for each good point Re. solutions].

<u>Problem areas.</u>
Management of foreign currencies and associated FX risks
Cash collection and repatriation.
Subsidiary and associate ownership.
Subsidiary and associate financing (including inter-company loans)
Trading with the countries in question
What to do with profits/ dividend policy
Bribery and corruption
Tax and changes to tax
Product pricing and transfer pricing
Government red tape, interference and expropriation
Inadequate banking products, systems and competence.
Local company ownership

<u>Solutions to the chosen topics</u> – be creative but practical!

Question 5 **[23.4 mins, 13 marks]**

[Marking scheme: expect comment on materiality of the additional currency risk; looking for evidence of understanding of emerging market conditions – see bullets 1 – 7 below; expect to see an outline approach which takes account of the majority of issues raised; extra points for spotting that this is a risky strategy for a leveraged buy-out business].

Emerging market corporate presence is currently perceived as good for growth, given the flat performance of mature markets. However the price to pay is volatility which expresses itself most forcefully and immediately in exchange rate movements, which give rise to transaction risk on the P/L and translation risk on the B/S.

In mature markets derivative forward hedges exist to smooth volatility created by transaction and translation risks. In emerging markets these forward hedges may not be available or be available only in part. So ultimately natural cash market hedges may need to be adopted, e.g. adjusting price in local currency and borrowing in local currency. However both of these may be unfeasible in specific circumstances – the first for competitive reasons, the second for availability.

So there may be no short-term solution with the result that risks crystallise and the Group takes a hit.

However there may be a long-term partial solution which is to manufacture locally, but this involves long-term sovereign and business market risk.

The German company in the question has gone for local JVs with local operations, so in the longer-term local manufacture of the core product may be an option.

But the JV adds a further complication in that the JV owners risk preferences may be at odds with the parent. For instance, the German company's functional currency will be EUR and the JV will be local currency.

So any policy will need to take into account these emerging market dimensions.

1 currencies volatile and subject to shock

2 only some will be tradeable

3 some may be managed currencies

4 some will be only partially tradeable (untradeable) currencies

5 unavailability of local currency debt in significant amounts or at an affordable cost

6 JV partner may have different hedging preferences

7 Local competitors may have different hedging behaviour and different fx exposure profiles

There is no single right way but one approach is:

- Intragroup flows routed through a hub which assumes the fx risk

- Third party purchase by subsidiaries hedged locally as they arise or if not feasible then routed through the hub

- Hub nets exposures and agrees a policy with Group for 100% hedge as risks arise or for limited position-taking

- Subsidiaries made aware of how decisions they take can impact Group fx risk, e.g. delaying anticipated and planned cash flows like dividends, licencing fees.

Note that this (examiner's) suggested answer is quite a textbook response to this risk and a better answer will recognise that any action to take FX risk away from the people who are closest to the pricing decisions will cause inefficiencies and conflicts of interest. So the treasurer might want to centralise dealing to reduce costs and devise a policy but this might remove the incentive on local management to look properly into competitive pricing. If, say, a local currency depreciates then sooner or later the prices (on imported goods) must rise and the treasurer can't call that, it is an operational issue. In addition, dividends and licencing fees are risks of ownership, nothing to do with trading risks.

The planned growth over the next five years is almost wholly emerging market. FX risk will more than double in volatile markets where hedging is problematic.

This may be an unwise strategy for a leveraged buy-out trying to build stable e.p.s. for an IPO.

Question 6 **[23.4 mins, 13 marks]**

[Marking scheme: Q6.a. – two of (i) to (IV) below plus one other credible alternative to pass; Q6.b. – three points per alternative to pass; Q6.c. – expect three credible support points to pass].

Context

The scheme is already closed and 50% of members are no longer active while the other 50% are still employees but no longer contributing to the scheme.

If the acquisition goes ahead, the employees of the acquired company will be your company employees, working at all levels. So what happens to their DB, albeit closed, matters in terms of the signals it sends to them. More immediately, you need to convince the trustees that you are well-intentioned.

Q6.a. **(3.6 mins, 2 marks)**

The Examiner speculated when writing the Question that there would be four main possibilities – (i) to (v) below:

		% of Students who mentioned
(i)	Hold, assume passive role	57%
(ii)	Hold, assume active role	71%
(iii)	Exit, pay a third party to assume ownership.	71%
(iv)	Hold, outsource	43%
(v)	Other possibilities (7 were suggested)	57%

The "%" shows that 57% of students mentioned possibility (i), 71% mentioned possibility (ii) and so on. Possibilities (i) to (v) accounted for 81% of all possible "mentions", with a further seven possibilities – most non-viable – accounting for the rest.

[Moderator's comments: Arguably, these are split into two categories. The first is to go for option (iii), a "buy-out" which gets rid of the problem, buts costs cash up front. This might mean ending accrual for the "actives". The second is to stick with the scheme and then think a bit more deeply about investment policy, perhaps added to making a large contribution. The second alternative requires management to then think about investment policy. The more that is paid in as a contribution, the more the policy can be de-risked. Active, passive and outsourced investment policies can all be either risky or conservative. So the three alternatives seem to be:

1. Buy out
2. Keep on and stay risky (it is risky as it is)
3. Keep on and go less risky (probably needs a contribution)

2 and 3 probably need co-operation of the trustees]

6.b. **(14.4 mins, 8 marks)**

(i) Long term involvement in an unfamiliar area with the drain of the deficit and uncertainty about further deficits. Result: deficit increases dangerously.

(ii) Possibility of economic savings in the longer term but if you get it wrong someone else's problem becomes yours. Result: possibility of downside greater than deficit; cost of acquiring expertise; upside more likely than with

(i) but an extra function to manage for legacy purposes only.

(iii) Exit, pay a third party to assume ownership. Significant cost of making good the deficit but achieve certainty and avoid being tainted by a problem of someone else's making. Result: certainty.

(iv) Outsource to a third party if you can't afford to exit now. Result: Reduce uncertainty of (i) at a cost.

6.c. (5.4 mins, 3 marks)

Exit now if funds permit, get certainty, avoid possible distractions in an unfamiliar functional area which could result in making matters worse – a useful point to make to the trustees; could then either negotiate the risk adjusted cost into the acquisition price or can treat as a post-acquisition restructuring cost and possibly amortise?

Question 7 (25.2 mins, 14 marks)

[Marking scheme: for both parts – combination of number of points, relevance and quality of discussion; as a guide, 6-10 points for Q7.a. and 4 minimum for Q7.b.]

<u>Summary of the economic background to the Q:</u> The case for reducing debt tax relief is that cheap debt encourages leverage which inevitably leads to crises. Removing debt relief would dampen economic growth – but might increase financial stability.

And shifting the tax relief to equity holders would mean more continuous scrutiny of corporate investment decisions.

However the status quo suits govt in that it can accelerate economic activity now (the future will be someone else's problem) and it can readily create conditions which will enable banks to respond quickly to demands for credit.

Q7 (a) (16.2 mins, 9 marks)

Ingredients for the discussion:

- Remove corporate debt tax relief (i) and cost of debt increases, WACC increases, balance between debt and equity shifts towards equity (CRA revenues down!), lower PAT – if <u>all</u> countries apply the shift in relief.

- Companies with bank debt but without access to equity markets worst hit, e.g. SMEs

- Also asset intensive businesses which can provide asset security for bank debt but are not attractive as growth stock

- Companies will seek off balance sheet finance where some other party gets the tax relief and passes it on

- Companies will retain more cash instead of debt headroom or committed facilities

- If not applied globally, could force firms to move

- Or shift debt to subsidiaries which are not affected

- Subsidiaries not affected could borrow and fund those which are with equity. So these subsidiaries need to be creditworthy or enjoy guarantee support.

- Impact on private equity firms

- So big shift in intra-group funding profiles

- Lack of equity market capacity could force firms to issue equity in other currencies

- Will corporate economic activity and bank debt decline or will corporate bank debt be attracted elsewhere? Reduction in bank debt dependence would please the bank regulator. However banks are a very responsive source of funding when government wishes to stimulate the economy.

Q7 (b) **(9.0 mins, 5 marks)**

- Government can compensate for loss of debt tax relief by reducing corporate tax rates and/or reducing tax on equity returns

- If tax on equity returns is reduced, then equity market capacity should increase

- So the impact on economic activity could be neutral but returns to corporates would decline to the advantage of equity holders

- In short, retained earnings would go down, forcing companies to continually compete for new funding and equity holders would have more funds to invest and would continually need to decide where to do so.

- But not all equity investors re-invest their dividends. Some will wish to use dividends to fund current expenditure – e.g. pensioners, charitable trusts.

- However, this expenditure increases consumer demand, so will encourage fixed capital investment

- These conclusions need to be qualified by the method used by the Government to transfer tax relief to the equity holder, e.g. relief on the initial investment, relief on dividend receipts, relief on disposal capital gains or an overall reduction in corporate tax.

- So the implication for corporates would be the need to focus more on equity investors as a source of funds and more on equity market performance management and communication. This would probably require a re-balancing of relationship management resources for bank debt, capital market debt and equity market debt and more granularity in the equity market element.

Question 8 **[18.0 mins, 10marks]**

[Marking scheme: looking for evidence of a framework for differentiating the outsourceable rather than a list of specifics; if a framework – e.g. core/non-core – then a credible explanation of it plus a few examples; if a list of specifics, then say 10 covering a broad range of circumstance].

As the corporate treasury function has developed and matured since the 1970s, the knowledge and skills (know-how) necessary to manage it have become better understood, more formalised and much better documented as a body of knowledge. In parallel, IT communications and data processing developments have allowed the automation of the more routine treasury operations. And as business has globalised the materiality of treasury decisions about funding and risk management have made the function a key part of the company, with a particular need to understand the business as well as the financial dimensions.

As a consequence, bigger companies with large treasury operations have sought to distinguish between the strategic and the operational – or using slightly different terminology – the core and the non-core. The motivation has been to focus treasury management expertise on the strategic/core activities which add value and automate or at least streamline the operational/non-core which may add little value and merely distract. The logical extension of this thinking is to outsource the operational/non-core.

The Know-How Matrix characterises three treasury functions – Process, Management, Strategy – in terms of how widely it is disseminated – Universal, Sector Specific, Company Specific, Individual – and therefore how easy it may be to outsource.

TYPES OF KNOW-HOW

KNOW - HOW MATRIX	**UNIVERSAL**	**SECTOR SPECIFIC**	**COMPANY SPECIFIC**	**INDIVIDUAL**
TREASURY FUNCTION - **PROCESS**	****	***	**	*

MANAGEMENT	***	**	*	CORE?
STRATEGY	**	*	CORE?	CORE?

key: ease of transfer/i.e. outsource: **** = easy * = hard

For these bigger companies/larger treasuries the non-core operational functions which are common to most corporate treasurers or at worst sector-specific are more likely to be outsourceable IF there is a significant cost or nuisance saving.

The implication for the outsourcing company is that it will probably need either scale or IT efficiencies or both to be successful.

The above relates to larger companies which will have developed Company Specific/Individual Know How about treasury and will wish to extract value from that. These companies will go to Application Service Providers (ASP) to outsource.

At the other extreme, companies which have very basic treasury needs or are relatively small or new will go to Business Service Providers (BSP) who will provide a full service outsource.

ASPs:
- Access via web-based platform
- Low cost but data on third party server so there is potential business continuity risk

BSPs:
- Long term contracts
- Tailored software
- Possibly access to other services

Specific circumstances favouring outsourcing:

- Companies with large centralised group treasuries
- JV of two companies, neither with a treasury, but needing one set up at short notice that is adequate
- International company with widely dispersed treasuries wishing to improve visibility and control
- Companies which have hit the headlines because of treasury-type failures
- Small start-ups
- Companies left on the shelf after a merger/acquisition which need a treasury function until acquired by a third party

- Companies with basic but significant treasuries which don't want to hit the headlines but haven't got the capex to invest in development and systems
- Companies with subsidiaries in complex jurisdictions – at one extreme accounting/tax/legal complexity, at the other political/cultural/economic complexity

Your first contribution to your new employer's plans might be to question which approach it prefers and has the resources to pursue: ASP or BSP?

Refs in "The Treasurer":

May 2014, pp38-9: Based on 4x4 matrix using Product/Company Life Cycle concept, ie 1 Start-up, 2 Rapid Growth, 3 Maturity, 4 Gradual Decline mapped against A Outsourcing Goal, B Outsourcing Needs, C Typical cost of O/s, D Key Relationship Drivers, E Exit strategy. Helpful but not treasury specific,

Jul/Aug 2014, pp 36-37: Treasury specific, why / why not, concepts and causality – quite helpful.