TREASURY, RISK AND FINANCE PROFESSIONALS

ACT

The Association of Corporate Treasurers

Examination Paper, Solutions and Examiners Report

MCT ADVANCED DIPLOMA

CASE STUDY EXAMINATION

October 2012

This examination is based on Global Spirits Case Study

QUESTION 1

You are asked to analyse the risks inherent in the company's business and the company's chosen strategy, but ignoring the risks associated with the company's financial structure and treasury activities.

Required:

Review the most important risk factors, whether positive or negative, based on your analysis and summarise the overall level of the company's business risk on a scale of 1 to 10, with 1 being lowest risk and 10 highest risk.

(10 marks)

QUESTION 2

You are asked to analyse the delivery of shareholder value by the company. For the purposes of this question assume that one has bought all the share capital at the start of 2006, when the share price was 914p, received all the benefits and entitlements of shareholders, then sold at the end of 2011, when the share price was 1273p.

Required:

a) Calculate, as best you can in the time available, the internal rate of return (IRR) on the shares, from 2006 to 2011, by discounting the relevant shareholder cash flows.

Make clear all your assumptions as to the amounts and timing of cash flows e.g. interim and final dividends.

(9 marks)

b) How good was that return? Explain the criteria you use.

(2 marks)

c) From your financial and non-financial analysis of the company's business and its track record, what factors might give you confidence that the company can continue to deliver shareholder value? What factors might threaten shareholder returns?

(3 marks)

(Total 14 marks)

QUESTION 3

Required:

a) Given your analysis of the company's financials and non-financials, what in your opinion are the five most important treasury/finance issues confronting Global Spirits in 2012? Briefly justify your choice.

(5 marks)

b) The treasury/finance issues you have chosen may already be fully or partially hedged, e.g. currency risk. Leaving aside any such risk mitigation already in place, prioritise your issues in terms of materiality for the company overall (business and finance) and justify your choice of issues and priority ordering. Quantify where possible.

(8 marks)

(Total 13 marks)

QUESTION 4

The company calculates separate WACCs for each country in which it has operations or is evaluating acquisitions and major capital projects. An example of the company's WACC calculations is given for Spain. The group WACC is based on external estimates from a sample of brokers' reports.

	Analysts' Group WACC	Company's WACC for Spain	Notes on Company WACC
Relevant risk-free rate	3.5% to 4.0%	5.2%	10-yr bond yield
Equity risk premium	4.5% to 5.0%	7.53%	5-yr average (5.2%)
Unlevered (asset) beta	0.54 to 0.66	0.70	comparables beta
Levered beta	0.64 to 0.76	0.84	re-levered beta
Tax relief rate on debt	18% to 30%	30%	US corporate tax rate
Relevant risk-free rate	3.5% to 4.0%	2.3%	US 10-yr RFR
Swap rate	-	(0.4%)	5-yr
Credit spread	1.0% to 2.0%	0.8%	Global Spirits 10yr CDS
Pre-tax cost of debt	5.0% to 5.5%	2.7%	
After-tax cost of debt	3.5% to 4.5%	1.89%	
Required return on equity	6.4% to 7.8%	11.5%	
Market cap % EV	79% to 83%	78.2%	
Net debt % EV	21% to 17%	21.8%	Global Spirits corporate ratio
WACC	6.0% to 7.7%	9.4%	

Required:

a) What are the likely reasons for the range of different values apparent on the key variables in analysts' calculations?

(4 marks)

b) What are the reasons for the differences between the Group WACC and the Spanish WACC?

(3 marks)

c) Assume the company wished to calculate a corresponding WACC for a joint-venture acquisition in Ethiopia, funded with a mix of offshore and local debt. The j.v company would not be highly leveraged. What problems would you expect and how might you deal with them?

(5 marks)

(Total 12 marks)

QUESTION 5

Required:

Write a review of the structure of the company's £8 billion debt portfolio, considering all relevant dimensions and give your views on why GS adopted such a structure. Identify any potential risks, problems or opportunities and discuss ways of dealing with them.

(10 marks)

QUESTION 6

The Group has 14 relationship banks, listed below in no particular order. The company also has 90 non-relationship banks.

.

- JP Morgan
- Bank of America Merrill Lynch
- HSBC
- Nomura
- CITI
- Santander
- Goldman Sachs
- Standard Chartered
- Barclays
- Morgan Stanley
- UBS
- Credit Suisse
- Deutsche
- RBS

Required:

a) Given your analysis of the company and its business, set out your thoughts on the number of relationship banks and the reasons for the inclusion of the 14 listed banks.

(5 marks)

b) Given what you know of the company's business and strategy, what are the functions of the non-relationship banks and what determines their number? Identify any issues you see in managing the total number of non-relationship banks.

(4 marks)

(Total 9 marks)

QUESTION 7

Historically GS translation risk has comprised mostly USD and EUR and has been managed using currency of debt issued and cross-currency swaps and other derivatives. Given the focus on emerging markets for growth, the proportion and variety of currencies other than USD, EUR and GBP is increasing. The recently amended currency translation risk policy, as described in the case under Treasury Risk Management (a) Currency Risk, states:

"The group's revised policy is, where a liquid foreign exchange market exists, to seek to hedge currency exposure on its net investment in foreign operations by using gross debt in foreign currencies and foreign currency spots, forwards, swaps and other financial derivatives within the following percentage bands: 80% to 100% for US dollars and euros and, at management's discretion, 0% to 100% for other currencies."

The table below shows growth in sales, total assets/liabilities, equity and gross debt over the past four years (CAGR 7%, 9%, 9% and 10% respectively between 2007-2011). The table also shows projected growth in sales and b/s numbers to 2016, assuming a 7% CAGR in each.

GLOBAL SPIRITS 2011

	2007 GBP m	2007-11	2011 GBP m	2012 GBP m	2013 GBP m	2014 GBP m	2015 GBP m	2016 GBP m
	Actual		Actual					
Sales Revenue (Assume CAGR 7% from Base Yr)	7481	CAGR 7%	9936 Base Yr	10631 Est.	11377	12173	13025	13926
B/S: Total Liabilities (Assume CAGR 7% from Base Yr)	13958	CAGR 9%	19777 Base Yr	21161 Est.	22643	24228	25924	27738
B/S: Equity Assume CAGR 7% From Base Yr)	4175	CAGR 9%	5985 Base Yr	6403 Est.	6852	7332	7845	8394
B/S: Gross Debt (Assume CAGR 7% From Base Yr)	5667	CAGR 10%	8195 Base Yr	8769 Est.	9387	10039	10741	11494

Required:

For all parts of this question, assume that 75% of estimated growth in 2011-2016 is due to smaller acquisitions in non-USD/EUR/GBP LDC countries, following the "route to market" strategy.

a) Estimate the increase in translation exposure created by these non-USD/EUR/GBP LDCs. Explain the logic of your estimate and why the increase in translation exposure may be material.

(4 marks)

b) What guidelines would you suggest for managing this risk, within the terms of the recently revised policy?

(9 marks)

c) In your opinion, is the recently revised policy of discretionary hedging between 0% and 100% appropriate?

(3 marks)

(Total 16 marks)

QUESTION 8

Global Spirits decentralises business management to subsidiaries so that these can focus their full attention on marketing to local customers and consumers. To facilitate this focus and to exploit economies of scale, scope and control there is a strong presumption in favour of centralising treasury at Group level.

However, in some countries full centralisation is not possible and also in some business structures where ownership is less than 100%. In these circumstances, some level of discretion has to be delegated to the subsidiaries, keeping the level under periodic review. This type of authority delegation is described as "dynamic balance" in the Treasury Organisation Profile.

Given the current strategic focus on rapidly developing LDCs, smaller acquisitions and probably more JVs rather than 100% ownership, dynamic balance is becoming more the norm than the exception.

Required:

a) Where Global Spirits owns less than 100% of a subsidiary and/or local conditions make centralisation of treasury impractical, in which areas of treasury activity might you expect to have to permit some local discretion?

(6 marks)

b) For each of the areas identified in 8a), indicate the degree of discretion that you would be prepared to delegate to:

i) A majority-owned subsidiary (5 marks)
ii) JV's which are owned 50-50 or less (5 marks)

(10 marks)

(Total 16 marks)

October 2012 MCT Case Study Global Spirits

1.0 Introduction

1.1 Overview

Global Spirits plc (GS) is a major alcoholic beverages business, operating globally selling spirits, beers and wines.

GS sells into 180 plus markets and has 105 production plants worldwide. Its shares are listed both in London and New York.

Summary Financials

	2010 £m	2011 £m
Turnover	9,780	9,936
EBIT	2,614	2,729
PAT	1,762	2,017
Gross Debt	8,764	8,195
Net Debt	7,311	6,611
Shareholders' Funds	4,786	5,985
Market Cap.	25,270	29,143

GS specialises in premium brands of which fourteen are "strategic", comprising 66% of sales.

Brands

	Spirits	Beers	Wines	Total
Strategic	13	1	-	14
Other	9	6	9	24
Total	22	7	9	38

The 14 Strategic Brands absorb 78% of market spend which totals £1,538m for the whole business. There are a further 24 major brands and GS has recently introduced ready-to-serve cocktails for home consumption.

Figure 1: GS's beer and spirits & wine businesses[1]

June 2011 Reported	Spirits & Wine £m	Beer £m	Group £m
Volume (litres)	**1,837**	**2,316**	**4,153**
NSV/litre	4.23	0.94	2.39
Net sales	7,761	2,175	9,936
COGS	(2,855)	(1,128)	(3,983)
Gross profit	**4,906**	**1,047**	**5,953**
A&P	(1,277)	(261)	(1,538)
Net brand contribution	3,629	786	4,415
Structure costs	(1,229)	(302)	(1,531)
Operating profit	**2,400**	**484**	**2,884**
Gross margin	63.2%	48.1%	59.9%
A&P/net sales	16.5%	12.0%	15.5%
Structure costs/net sales	15.8%	13.9%	15.4%
Operating margin	30.9%	22.2%	29.0%

1.2 Strategy

GS majors on marketing by achieving insights at the local level into consumer trends and shopper behaviour.

GS has global scale and in the majority of its markets it reaches customers and consumers through local teams with strong local expertise and networks. Where GS does not have local subsidiaries, it looks to expand organically through business partners and third-party distributors but it is also committed to explore opportunities for growth by acquisition and this may be the main source of growth, particularly in LDCs (Less Developed Countries).

[1] Figure 1 above and all charts and tables in Section 2 are sourced from sector research consultants.

2.0 Business Profile and Analysis

2.1 Overview and Chief Executive's Summary

Ten years ago GS's focus was on traditional, large, developed markets for their major brands. However, these were relatively low-growth markets. As for many global companies the focus has now switched to growing markets.

The general strategy is to sell to the increasingly affluent middle classes in LDCs the premium brands on which the business now focuses, ie 14 strategic brands and a further 24 major brands.

However their "route to market" for these consumers has taken time to develop. The current strategy is to look for LDC acquisitions which already have large domestic distribution capability for their own product (eg via supermarkets) and piggy-back that distribution capability by adding GS premium product to the customer order form. Quoting the Chief Executive (Annual Report 2010-11):

> "Fiscal 2011 was the year when our determination to emerge robustly from the economic downturn was realised.
>
> GS has increased growth year-on-year in our top and bottom lines, despite continuing weakness in some European markets and the United States. We have seen continuing gross margin expansion: it has been another excellent year in terms of free cash flow, and we have recommended an increase in the final dividend of 6%.
>
> Our outstanding collection of brands has been an asset as ever, but I would single out the performance of scotch whisky as a particular highlight. In a category which reached export values of £109 per second to the United Kingdom in 2010 – a renaissance which GS led – we are very well placed as the biggest participant in the category, and as owner of the leading brands.
>
> The strategy we have pursued, and the investment choices we have made, have set our business up to produce attractive and sustainable rates of growth in the medium term. GS is a strong business, getting stronger.
>
> Today's trading environment for our company is polarised between important, higher margin but lower growth markets – North America and Western Europe – and high growth markets in Eastern Europe, Africa, Latin America, and most of Asia Pacific. Our plan is for those high growth markets – currently around a third of our business – to represent 50% by 2015. This is a realistic goal, and we have continued our progress towards it in the past year.
>
> Having worked to build our presence in those markets over a considerable period, it is gratifying to see them reach a point in terms of scale and contribution where the payback for that commitment is clear. In fiscal 2011 we have made a step change in terms of the weighting of our investment in favour of high growth markets, with a view to further accelerating their development. I expect this trend to continue.

Alongside that move, we have undertaken a review of our operating model to ensure that our resources are deployed even closer to the market, and in those areas where the potential for growth is greatest. The review has encompassed changes to our regional structure and our central functions, ensuring we have the optimally sized and focused organisation wherever we operate.

Our acquisition activity in the past year will also support long term value creation. The acquisition of Eskise will transform our business in Turkey, one of the most exciting high growth markets in the world. I am pleased with the strategic position we have taken in Daphong in Thailand, and that our partnership with GSA in Honduras has been cemented via the purchase of a 50% controlling stake in Jalapa rum.

We are also privileged to have the unique opportunity to participate at scale in super premium Chinese white spirits, one of the largest, fastest growing spirits segments in the world. The ground-breaking approval of our application to increase our investment in Xinbei, secured in June, means we can look forward to working with our Chinese partners to further develop the Jinan brand both domestically and overseas.

We will continue to look at opportunities for acquisitions where we see a chance to strengthen our company. Targets we pursue will be those which make strong strategic sense for our business and where the valuation is sensible.

But we are also committed to growing this business organically, and I believe we have the platform to drive higher rates of growth in the medium term, delivering sustainable value for shareholders."

2.2 Product-Market Scope and Scale[2]

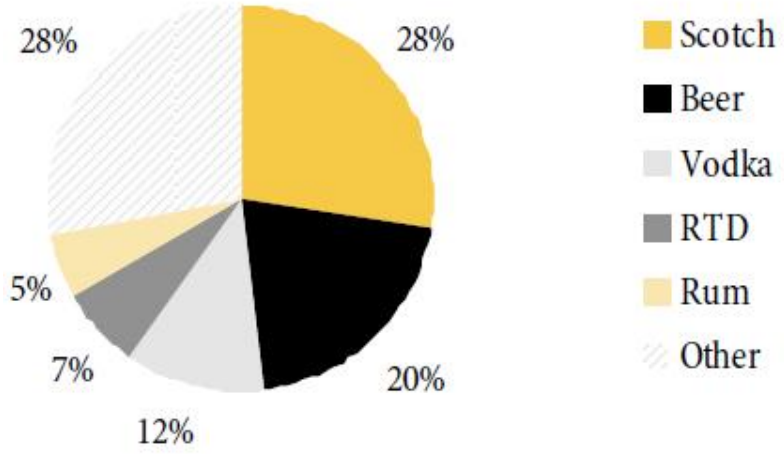
Scotch a major growth driver

GS has a broad representation across most alcohol categories but its emerging market exposure is much more concentrated with over 70% of net sales driven by Scotch and beer, which together account for nearly half of the group's net sales. These two categories are the real engines of GS's future growth in Latin America, Africa and Asia Pacific and are what differentiate the business from its competition, while vodka – the third historic engine – is an increasingly competitive category.

[2] The commentary in the rest of Section 2 is from the sector consultants material referred to earlier in Footnote 1

Figure 2: Scotch and beer are nearly half of the business

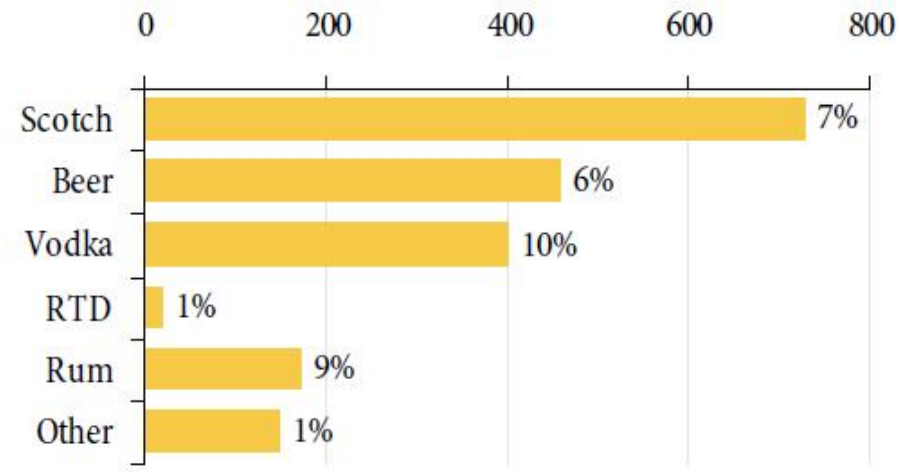
GS net sales by category (Dec 2011, pro-forma)



Note: We have used GS's reported net sales for the 12 months to December 2012 and added a full-year contribution from Eskise (raki) and Jinan ((baijiu)

Figure 3: Three key growth engines, Scotch the strongest

GS incremental net sales FY08-CY11 (£m, CAGR)



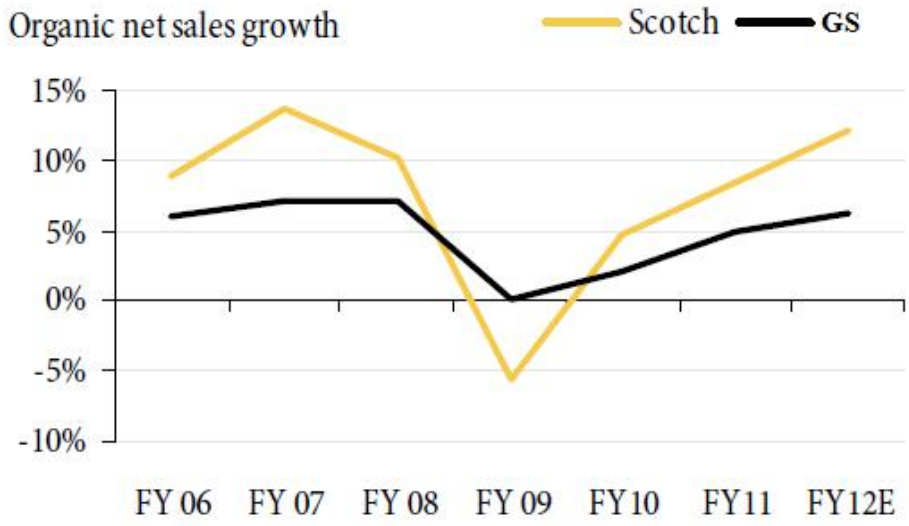
Note: Between June 2008 and December 2011 GS consolidated £348m of net sales from acquisitions. We have adjusted the net sales and CAGR to exclude the effect of acquisitions, but the growth includes the impact from currencies.

GS disclosed that Scotch was 27% of net sales in the year to June 2011, but with twice the level of organic net sales growth in the first half of fiscal 2012 (+14% compared to the group at +7%) we[2] estimate Scotch's share of net sales has increased to 29% as at December 2012. With the full consolidation of Eskise(Turkey) and Jinan (China) we calculate this share will fall marginally to 28%. On a proforma basis, Scotch is the single largest driver of GS's top-line growth, nearly three times the size of its vodka portfolio and 40% bigger than its beer business.

Higher growth at higher margins

Scotch has been the most significant contributor to GS's net sales growth over the last five years. GS's Scotch portfolio generated £2.7bn of net sales in fiscal 2011 up from £1.8bn in fiscal 2006, with the current rate of growth expected (as per a recent GS marketing presentation) to take net sales through the £3bn level by the end of fiscal 2012. This is 8% compound growth per annum over the last six years; a period which was distorted by the adverse impact of the Global Financial Crisis from which GS's Scotch business has quickly recovered to pre-crisis growth rates.

Figure 4: Scotch is leading the charge . . .

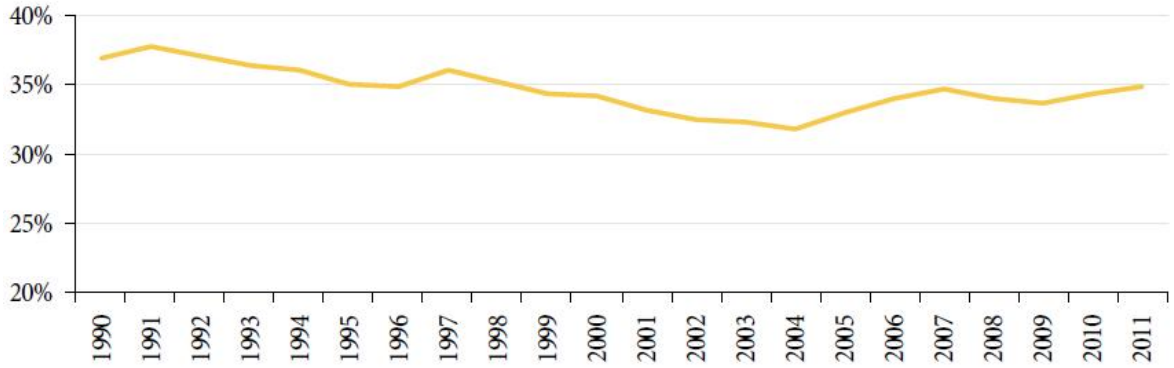


Two of GS's strategic Scotch brands have led this recovery. The largest, Robbie Burns, is being driven by strong demand across all regions and the second largest by the strength of the Latin American Scotch market. Another leading brand also saw some recent improvement but we would not extrapolate this as the brand benefited from a heavily depressed base period when there was further de-stocking in Spain. The recovery of yet another brand was in part muted by its leading position in South Korea where the Scotch market has moved into structural decline, exacerbated by price increases.

The Scotch industry had recovered but GS has continued to take world-wide volume share. From 2005 GS started to rebuild the market share it lost in Scotch since the early 1990s. This is a significant inflection point in the company's development because the period 2004/05 was when GS started to broaden the business beyond markets such as North America and Western Europe, where the strategy had been horizontal line extensions to drive incremental growth. Instead, GS started to build out into the emerging markets. Here Scotch was the important driver of incremental growth, not horizontally through line extensions, but rather vertically through premium and deluxe expressions.

Figure 5: GS reverses its share declines in Scotch

GS's world-wide Scotch volume market share



With GS's two top brands representing two thirds of GS's Scotch portfolio by net sales, we are confident in the sustained outlook for growth. Scotch is a premium-priced and premium-margin product, and so this sales momentum is accretive to group margins. GS disclosed in a recent marketing presentation Scotch represented one third of brand contribution, and based on our allocation of structural costs Scotch accounts for just under 40% of GS's operating profit, generating a 40% operating profit margin compared to the group average of 29%.

Figure 6: Scotch is over one-third of group operating profit

GS operating profit by category FY11 (pro-forma)

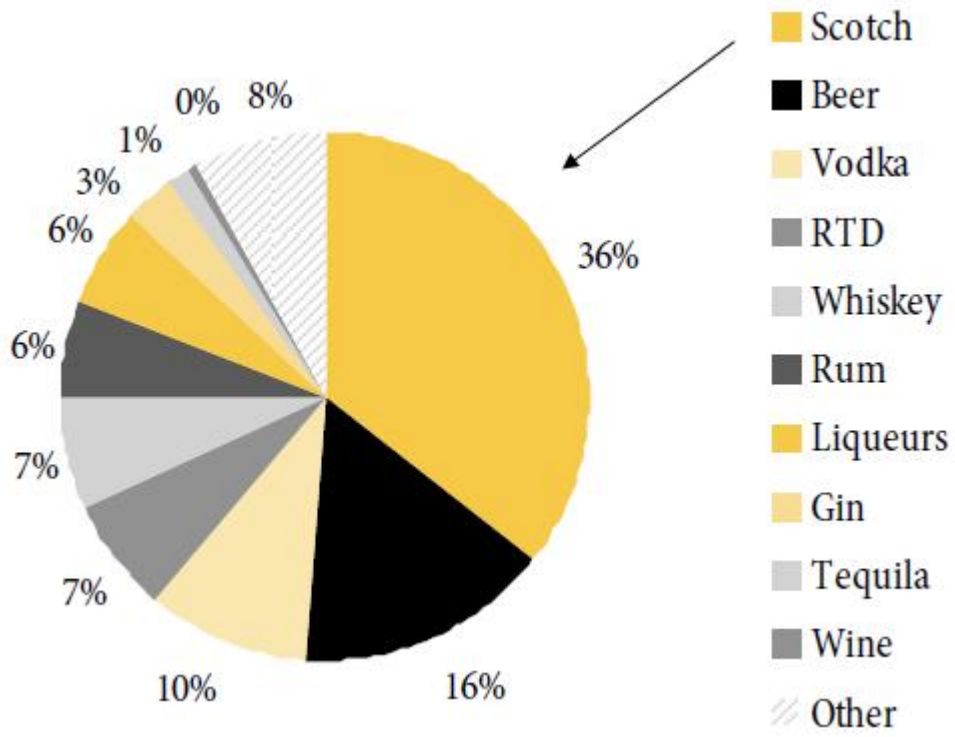
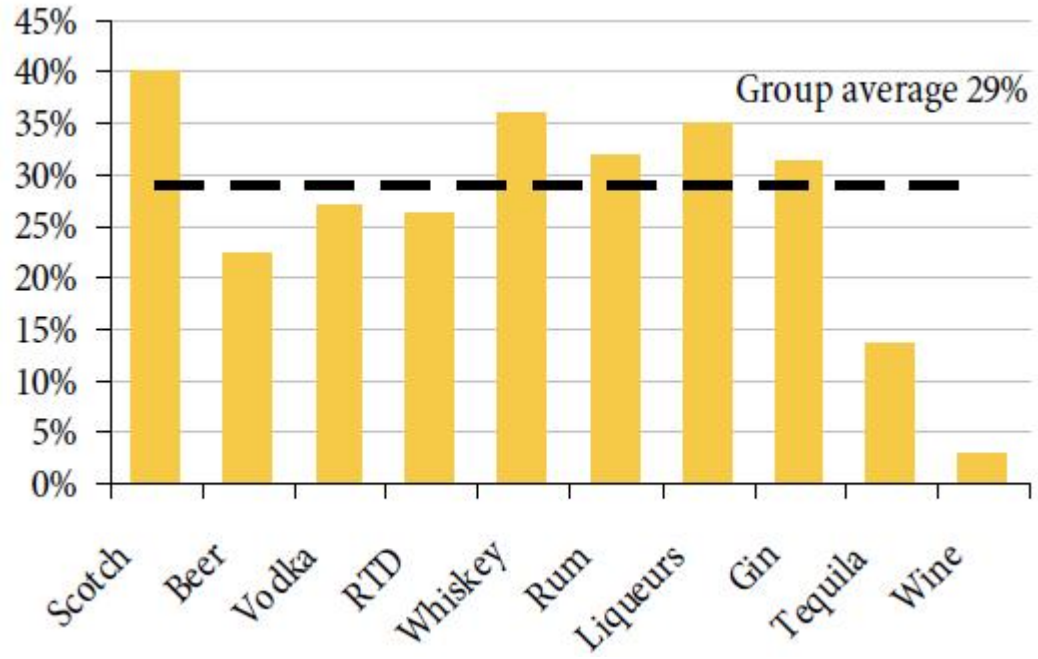


Figure 7: Scotch earns premium operating margins

Operating margin by category FY11 (pro-forma)

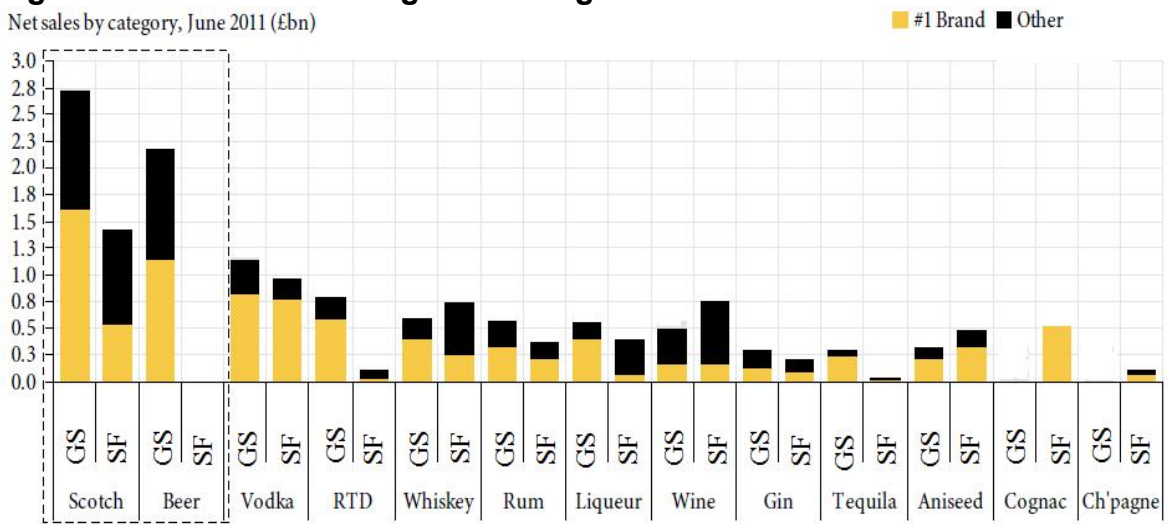


Scotch and beer drive GS's scale

We estimate GS's Scotch business generates £1bn of net sales more than its nearest competitor Spiritueux Forts (SF), with the Robbie Burns brand itself generating the equivalent net sales as SF's entire Scotch portfolio. When we look at the two groups' respective sales split by category, Scotch and beer are what set GS apart and account for a large part of GS's £4bn larger scale in terms of net sales. SF has a very interesting Scotch strategy, as presented at its recent Capital Markets Day, but it lacks the scale in Scotch of GS.

On the other side of the equation Spiritueux Forts consolidates sales from Cognac and Champagne which GS does not have direct exposure to. We are equally positive on the outlook for Cognac, as we wrote in our recent report on Camue Delamy('Coeur de Cognac' May 2012), and this gives both SF and CD an advantage over GS in China. It is worth remembering that shareholders in GS gain a comparable exposure to Cognac in absolute terms through its 34% stake in Bisquit-Bache although GS does not gain access to the all-important Cognac cashflows in China through its cost-sharing joint venture with BB.

Figure 8: Scotch and beer give GS its global scale



Scotch is one third of GS's balance sheet: investing for growth

GS has £2bn of Scotch sitting quietly maturing in casks in bonded warehouses in Scotland, which represents one third of the group's net asset value. This is a significant barrier to entry and a major capital commitment to the category.

2.3 The Way Forward

The end of brand imperialism

In order to understand why GS was late in building out its route-to-market in the emerging markets it is important to look at the history of the company. GS was created through the merger of Irish Stout and Mega Hotels in December 1997. Mega Hotels, which provided many of the top executives to the newly formed GS, was not in essence a drinks business but a consumer conglomerate with a penchant for property. Its origins lay in hotels, but since the 1930s its interests spanned spirits, dough, ice cream, burgers, pet food, eyewear, bingo, milk, betting, tobacco, pubs, restaurants, brewing and off-licences.

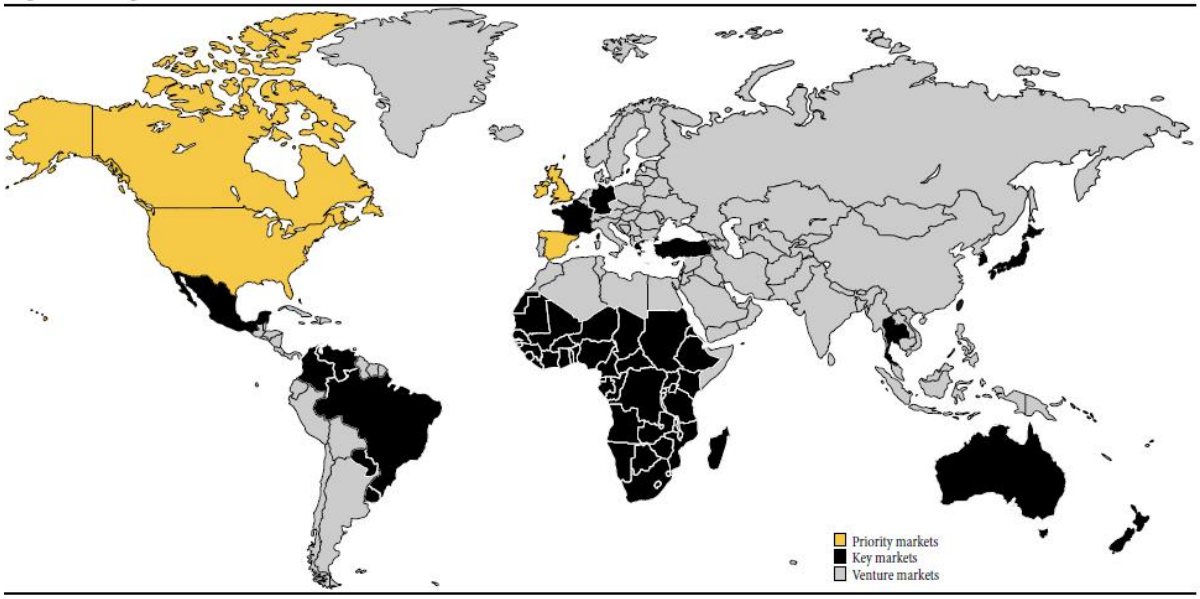
Mega Hotels traded assets and was a late convert to the EVA school, a mantra that then infused GS. Returns meant focused capital allocation in the anti-conglomerate, post-Hanson world and in 2000 the group announced the strategic realignment behind its premium drinks brands. It disposed of two large food subsidiaries, as well as several local spirits brands, eg in Brazil and in India, which were lower priced, lower return and by extension 'non-core'. Of most significance was how GS divided its business, thereby highlighting its world view. It grouped its business into three key divisions based on the then *current* size of the available profit pool for premium drinks, and focused its capital allocation accordingly.

- First there were the '**Priority Markets**' of North America, Great Britain, Ireland and Spain. These were the deepest profit pools for premium drinks and therefore received the highest focus and capital investment because this is where the greatest incremental returns were at the time.

- Then came the '**Key Markets**' which were a piecemeal collection of relatively established profit pools for premium drinks in the developed world, such as France, Germany, Australia and Japan, or in the emerging world for Scotch (Brazil, Mexico and Turkey) or beer (sub-Saharan Africa).

- Finally there came the '**Venture Markets**' which by their name indicated that GS saw them as underdeveloped, high risk and potentially dilutive to returns. Such markets were not a focus for either capital or operational investment. These markets included China, India and Russia (or nearly 40% of the world population).

Figure 9: GS's old world view



The development of GS's DNA

In hindsight GS had built its business model around increasingly indebted and free-spending developed world consumers while leaving the vast numbers of emerging middle class consumers to discover their brands through chance. The risks to this model were brought home during the global financial crisis when the consumers in the Priority markets traded down and in Spain and Ireland the addressable profit pool for premium spirits shrank significantly.

As recently as 2004 GS still grouped China and India into its 'Venture Markets' division. These markets were not a focus for investment for GS back then, as described in the 2004 annual report:

> *"In these markets there is a focus on fewer brands and lean but flexible organisation structures are deployed whilst global best practices in areas such as consumer marketing, customer management and people development are applied."*

While SF was reinforcing its local position in markets such as China and India,

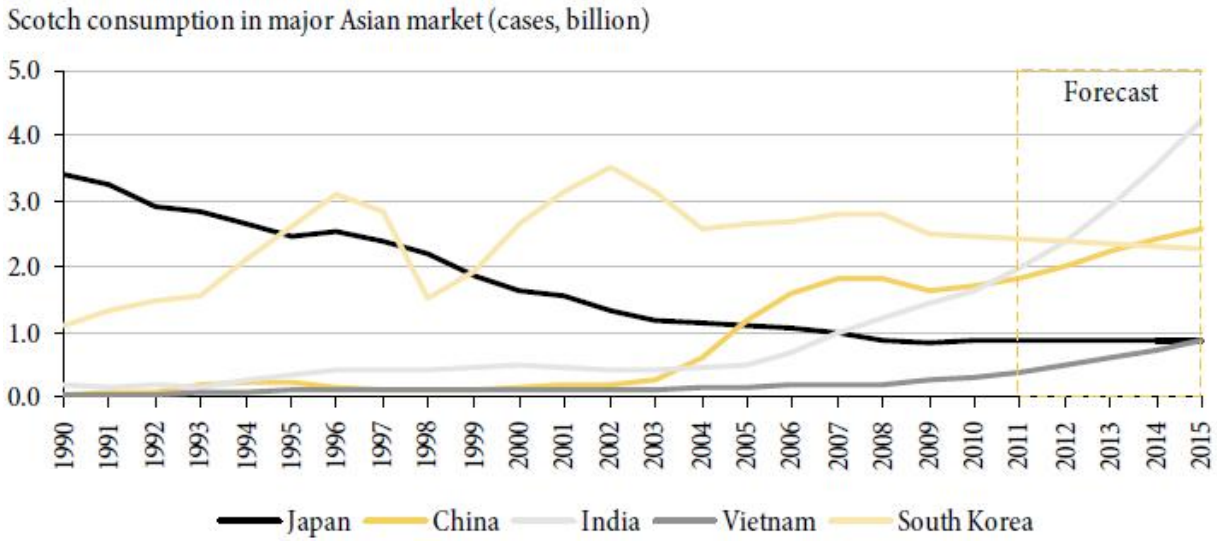
and deepening customer relationships and consumer insights, GS was not. GS was employing what we have described previously as a brand imperialist strategy, rather than cultivating local roots.

In hindsight we can chart the slow, seven-year process from taking the decision to focus on premium drinks to finally publicly acknowledging the long-term potential of Asia. Up until the late 1990s, GS's products were simply out of reach of most emerging market consumers. The focus of the business was selling premium products to affluent (and increasingly leveraged) middle class Americans and Europeans.

Japan had been the great hope of the Scotch industry a decade before and when this market imploded it hit profits hard. In 2000 the Scotch industry had experienced a second Asia disappointment as markets such as Korea and Thailand were hit hard in the Asia crisis of 1997.

In 2000 China and India barely registered as markets for Scotch. But the pace of their subsequent development was almost exponential after 2003 and by 2005 China surpassed Japan in cases of Scotch consumed, as did India two years later, with Thailand expected to do the same in 2015.

Figure 10: The land of the sinking sun



It was not certain, as GS was setting out its strategy in 2000, whether Asia would ever be a big market for Scotch. However, by 2005 the growth potential could not be ignored especially as by then Spain, the growth engine of the 1990s, had been in decline for four years.

If GS was to take full advantage of this potentially huge cycle of growth for Scotch in the emerging markets, it would need to rethink its route-to-market in Asia. Its brands, despite significant brand equity, would not sell themselves. GS had to take a leaf out of SF's book and build more direct sales and distribution capabilities; even if it meant diluting margins and returns, this was the necessary

trade-off for future growth.

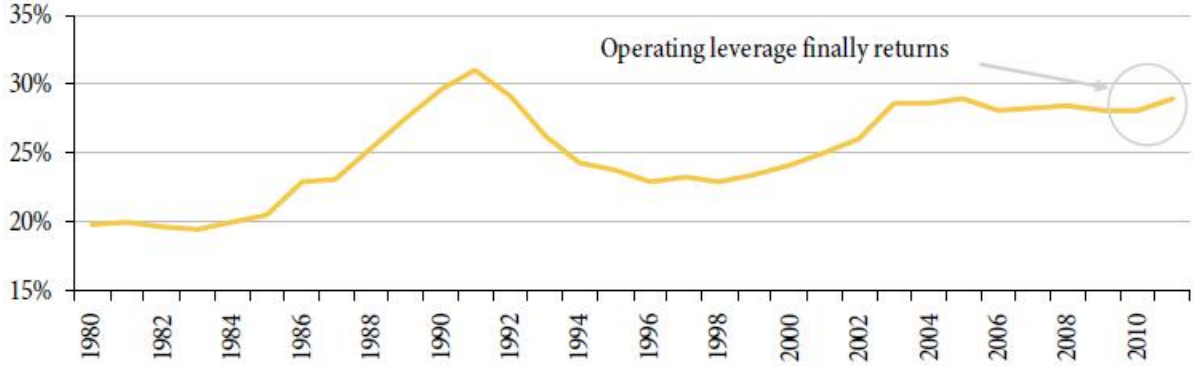
2.4 Operating Leverage, Costs and Margins

Investing to rebalance

When we upgraded GS to Buy back in January 2010 it was based on our analysis of the developments within the cost base to dispel the view that GS lacked underlying operational leverage. There was nothing endemically wrong within the business. Instead GS had increased significantly the investment to address the need to build out its emerging market route-to-market. To assess this we created what we call GS's synthetic margin, which is a grand term for combining the profit streams from Irish Stout and Mega Hotels that were to form GS – borrowing on the work we conducted in the Scotch section.

Figure 11: Leverage at last

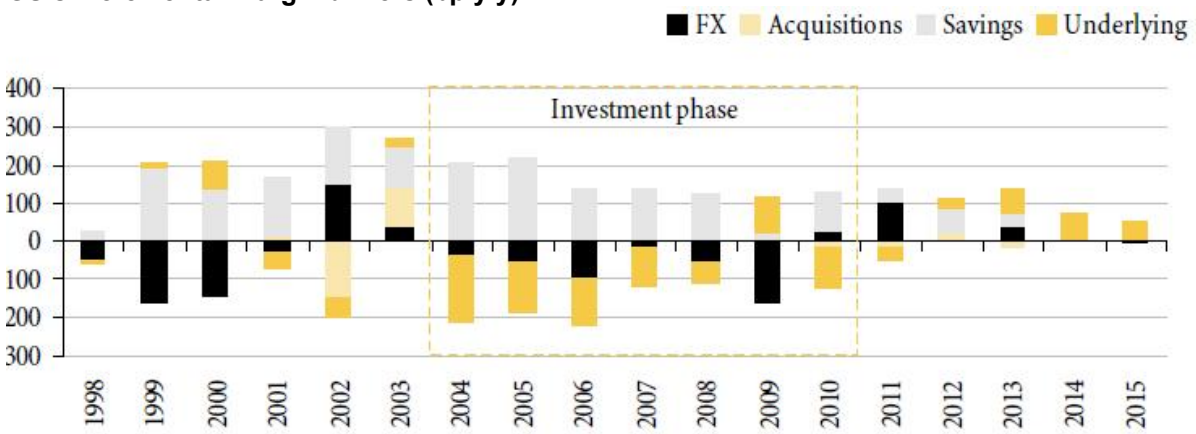
GS's synthetic premium drinks operating margin from 1980



When the original merger savings ran out in 2003 this coincided with a period of GS's margins flat-lining. Despite further savings from later acquisitions and a Supply Chain programme, margins remained stubbornly in the 28-29% range, failing to break the previous 30% ceiling achieved in 1991. Our analysis below highlights how the cost savings helped offset not only transactional currency pressures but also helped offset negative underlying leverage from increased investment.

Figure 12: Currencies and investment weighed on underlying leverage

GS's incremental margin drivers (bp y/y)

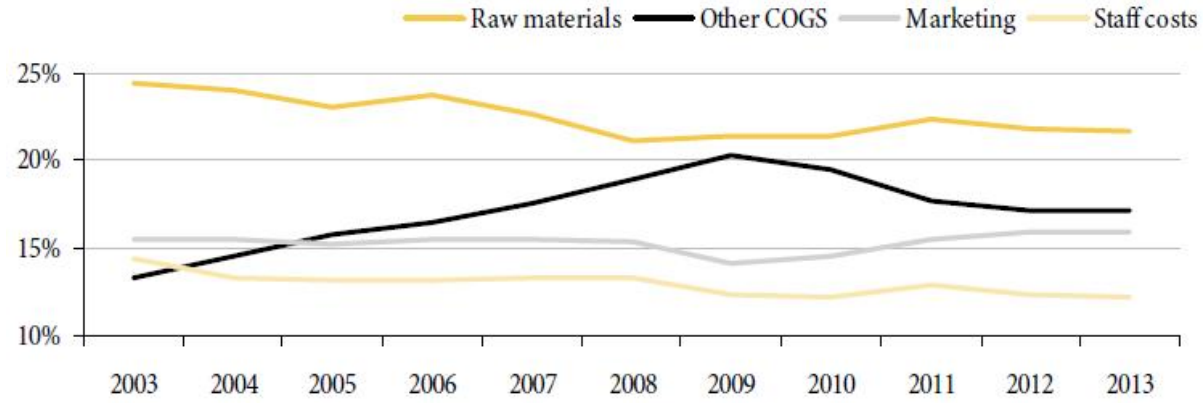


Central to our investment thesis on GS is the idea that the underlying business did not report any leverage during the period FY03-11 due to a deliberate investment decision made by management. Before we go into the detail of where this investment was made geographically we can identify the specific cost items where the incremental spend was going.

The usual suspect would be A&P spend but this has remained broadly stable over the period at between 14% and 16% of sales, and we forecast this to rise again. Raw materials have demonstrated good operational leverage as have staff costs. The main cost item that eroded GS's margin potential was what we term 'other COGS' as detailed in Figure 13. This figure is not disclosed by GS but can be derived from the net of its raw materials costs and cost of sales, both of which are disclosed.

Figure 13: Other cost of goods absorbed all the underlying margin potential

GS's costs/net sales



'Other COGS' increased from 13% of net sales in FY03 to 20% at its peak in FY09. This eroded the £500m of supply savings released between FY04 and FY08, which can be seen reducing raw materials as a percentage of net sales. When we upgraded GS in 2011 we had had the first evidence of some operating leverage into this cost item, which fell by 90bp of net sales in FY10. This leverage accelerated much more dramatically in FY11 with a further 180bp

decline. We forecast another 50bp in FY12. Whatever this cost item was, it is finally starting to contribute rather than erode GS's margin potential.

All well and good but what was in 'other COGS'? By a process of elimination and using some of the disclosure in GS's various presentations on the supply chain we can determine this line item is where logistics, manufacturing and related overheads are accounted for. GS's cost of goods line breaks down by function and specifically within raw materials by input cost type, as shown in Figures 14-15.

Figure 14: Breaking into the COGS

GS COGS breakdown, FY11

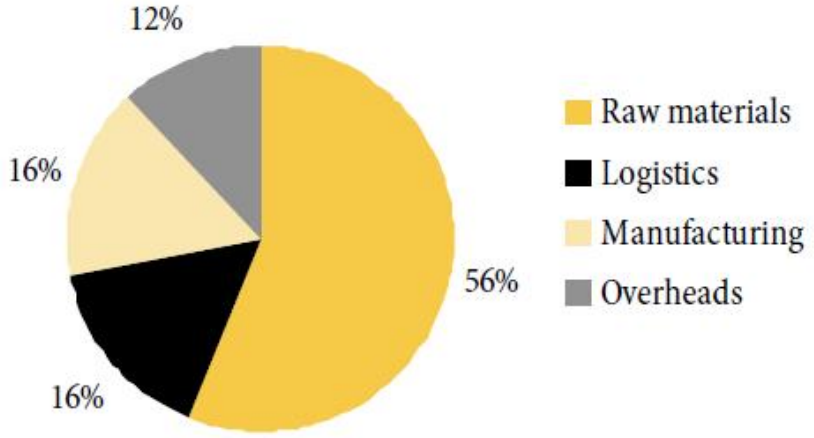
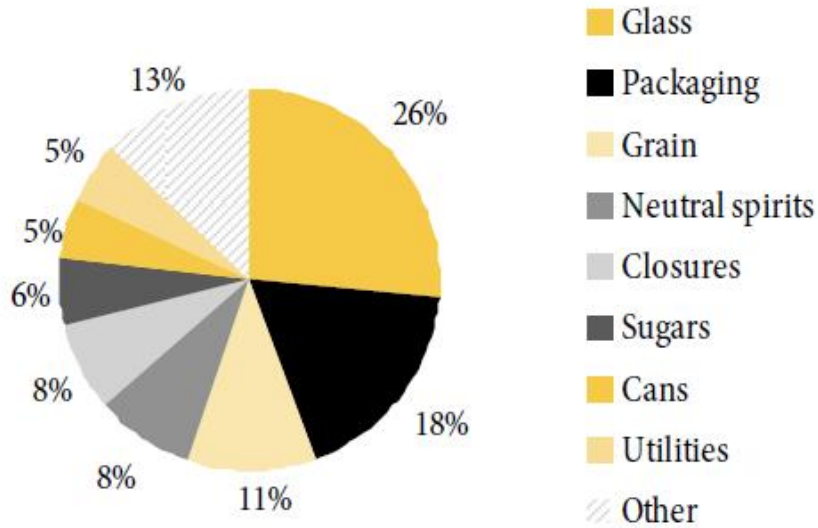


Figure 15: A spread of raw materials

GS raw materials breakdown, FY11



Ultimately, GS has been investing in route-to-market capabilities and manufacturing capacity to support growth in the emerging markets, and this

investment process is now largely behind us.

2.5 GS's new world view

Conceptually it was this change in GS's world view which prompted the step-up in investment as it closed the gap on its more Asia-centric competition, above all SF. It is important to establish actual 'real world' examples of where this spend has gone. The most significant we have identified as follows:

- In **China,** GS created an in-market company, GS China Ltd, in 2007 and has since expanded the sales force to 200 (SF China has 550). The Jinan acquisition further broadens GS's route-to-market but currently there is limited cross-selling opportunity. Robbie Burns benefits from the cost sharing joint venture with BB in targeting the modern on-trade with 550 distributors, and while this leaves marginal profits from its Chinese Scotch brands, as GS improves the mix and average selling prices of these brands they should provide additional internal funds to support the further expansion of its route-to-market.

- In 2006 GS built an Asian distribution hub in **Singapore** at a capital cost of $13m with original capacity to handle 3.5 million cases but which was then extended to eight million (total Asian volumes were some 13 million cases in fiscal 2011). This gives GS greater visibility and control over its channel into the otherwise opaque Asian region.

- Whereas previously GS targeted **India** through the Duty Free channel, it has since created an in-market company and now has 250 direct sales people with another dedicated 350 sales people at the distributor level. GS has expanded into tier two cities and should have over 80% of the 60,000 addressable outlets for alcohol covered, with the target over 90%.

- GS established GS Indochina Ltd in **Thailand** back in December 2006 and gained a licence to distribute finished spirits products from January 2010 signalling a step-up in investment, with close to 200 direct employees today. Further strengthening its position, GS formed a strategic partnership in January 2011 with Daphong and invested £33m for a 23.6% stake in the company, which is the largest domestic branded spirits producer in Thailand. This stake has since been increased to 30%.

- In **Africa**, since 2002, GS has integrated all of its beer and spirits sales and distribution, such that it is now running a fully integrated model in all the markets where it has direct representation. This is already generating revenue synergies for the spirits brands as they take advantage of GS's established route-to-market in beer.

- GS has in-market companies and dedicated distribution across **Latin America** and now has 600 direct sales people in the region, up from 500 in FY11 which had already been increased significantly. In **Brazil,** GS is currently in the process of significantly enhancing its distribution coverage which will result in access to a network of 4,500 sales people with near full national coverage.

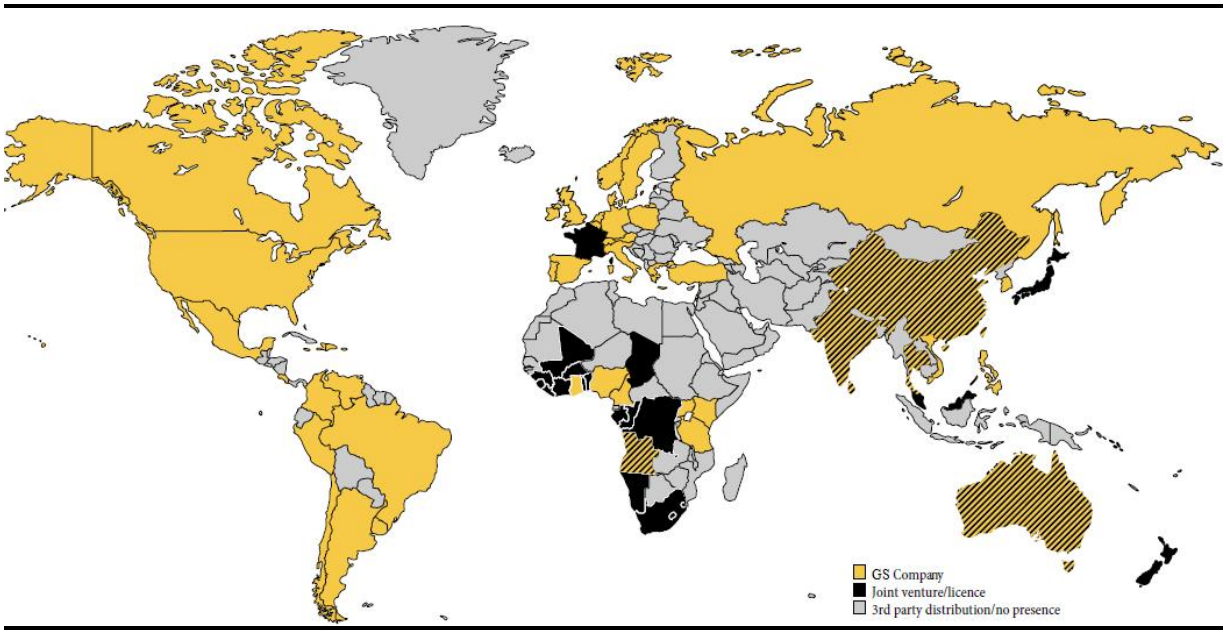
This has been further enhanced with the recent Pele acquisition, a leading premium cachaça brand, with a sales network into over 250,000 outlets.

- The acquisition of Eskise in **Turkey** gives GS access to the leading sales network of 650 sales people covering 57,000 outlets or over 80% of the addressable total. This is already having significant revenue synergies for GS's international brands, especially Scotch and vodka.

Under the new operating model review there has been a reallocation of investment from the lower growth developed markets into the higher growth (and potentially lower returns in the short-term) emerging markets. GS however continues to reinforce its route-to-market advantage in the **US**. After recent acquisitions in North America, GS moved to a single dedicated sales team at the distributor level in each state; the project was called 'Next Generation Growth' or NGG. Since then GS has gone a step further and over half of its volumes now have dedicated *divisions* within the distributor with a GS-specific general manager (often an ex GS employee). This allows for a significantly enhanced focus on brands, better allocation of resource and promotional slots, as well as deeper sharing of IT and other best practices.

A reallocation of investment away from **Western Europe** could mean GS lags behind in a recovery, as and when this materialises. This is especially the case given GS's main competitor in Europe, SF, continues to invest across the region. But GS still reinvests between 14% and 15% of net sales in marketing, which we assume edges up to 15% over time, and structural costs (on our analysis) are still over 10% of net sales, so GS still has a significant interest in Western Europe.

Figure 16: GS new world view

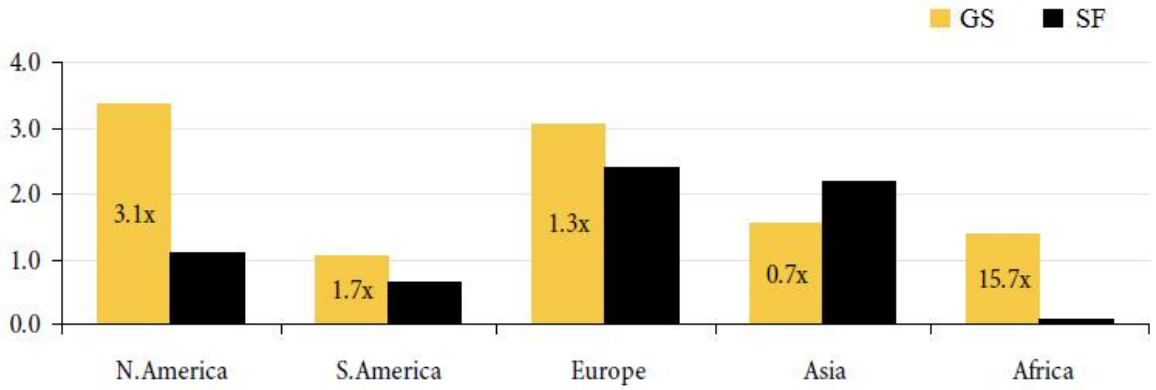


A broad-based route-to-market

GS's scale advantage in net sales, vs its nearest competitor, from a regional perspective is in North America, although the company is nearly twice the size in Latin America, multiples bigger in Africa, and post Eskise in Turkey bigger in Europe.

Figure 17: GS has a scale advantage in all regions except Asia

Net sales by region £ bn and GS's relative size to SF

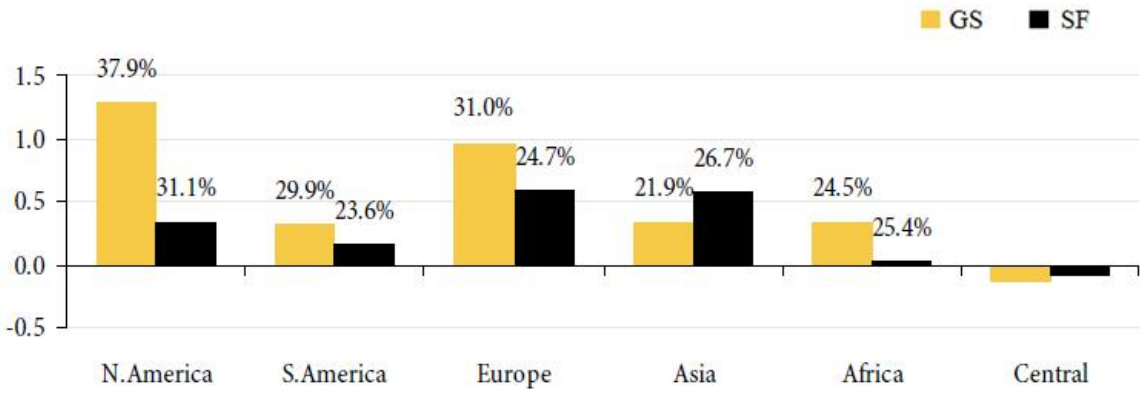


While much is written on the Asian opportunity for the spirits companies, GS by virtue of its positioning in Scotch and beer, which are much more broad-based products, has a less Asia-centric growth opportunity with over £1bn of net sales in each of Latin America, Asia Pacific and Africa. For SF, only Asia has crossed this threshold.

We are interested in understanding the level of sunk structural costs GS has in each of its regions to assess whether the premium margins it reports in most regions is a function of scale or relative under-investment in structure compared to SF. To do this we have taken the operating margin for each by region, as reported, but have had to strip out our best estimate for SF's central costs, which it allocates to the 'regions' GS reports them separately.

Figure 18: Profitability follows relative scale

Operating profit and margin by region (£bn and %)



We have then used various assumptions in terms of gross margin and A&P spend, to back out what the fixed structural costs are in each region.

The gross margins by region are broadly the same, although SF's are lower in Asia which we attribute to its greater exposure to local whiskies in India. Marketing spend does vary determined by scale. The clearest example of this is in North America where GS spends more than twice the level as SF but at four percentage point lower reinvestment rate of net sales. Using our assumptions we derive figures for sunk fixed infrastructure costs by region for both.

In conclusion, we are reassured that GS now has a comparable investment in structural costs in key regions such as Asia, South America and Europe (although Europe benefits from the recent Turkish acquisition) reflecting a global route-to-market for its brands. In Asia it is worth noting that with the Chinese consolidation plus the investments made in South East Asia as well as its significant businesses in Australia and Korea, GS now has a higher level of structural costs across the region – though it still lags SF in key markets such as China and India.

Asia has been much of the focus of GS's increment investment. During the period FY06-11 India and China, above all, were running at a loss on our estimates as GS built out route-to-market and invested behind brands in these markets. We expect both of these markets to move into profit over the period FY13 to FY15, first led by India and then China. The other Asian markets, such as Thailand, have already passed this inflection point.

Benchmarking the sustainable return of leverage

GS now has a route-to-market that befits its market-leading brand portfolio, and should be able to support a sustained return to operating leverage as the top-line growth pulls through margin expansion. In addition to the *natural* leverage into sales growth in our previous report we identified some underlying inefficiencies that could be extracted from the business.

Since then GS has announced further savings from the operating model review which are expected to result in annualised savings of £80m by the end of 2013.

2.6 GS Productivity, Efficiency and Pricing

Improving productivity to be top-line driven

The most basic measure of productivity we have used is net sales per employee vs cost per employee. We can see that while GS has consistently improved its productivity since 2003, the company has struggled to increase this at a faster rate than cost per employee.

In 2009 and 2010, however, the company was able to improve productivity but not in 2011 due to a 2% hit to sales from currencies (mix of employees do not fully match currency of revenues), compounded by a 2% increase in headcount as the company continued to build out resources in the emerging markets. In our model we assume that GS can now start to improve its productivity measures at a faster rate than cost per employee, especially now that a lot of the more

expensive ex-pat general managers are now in place in various developing markets.

While we have conducted most of our benchmarking for GS by splitting out its beer business to assess the relative efficiency of its spirits & wine business against its distiller & vintner peers, and similarly for brewing with its brewing peers, it is not possible to break out head count by function. Consequently we have benchmarked productivity (net sales per employee) at the group level.

The average sales per employee for spirits is £455,000 but lower for brewing at £244,000 due to the lower end price per litre and more production-led nature of the business. Given that 22% of GS's net sales comes from its brewing business, the weighted average is £409,000 which is broadly in line with GS's total sales per employee of £414,000. GS does not appear to fall short on this standard productivity measure, being very much in line with its respective peer groups.

One of the most powerful ways of improving net sales per employee will be to increase the average selling price of its products, because volumes determine the physical costs required to support an enterprise. The highest productivity levels are from the luxury producers, while the brewers are lower largely because of the relatively low value to weight ratio.

- The spirits & wine companies we looked at have an average selling price of £4.86 per litre excluding luxury producers, compared to GS at £4.23 per litre. There is some scope for improvement which is central to the increased focus behind premium and deluxe brands, especially in Scotch.

- GS's beer business achieves a much higher average price per litre than its peers.

On the cost per employee GS's average is £53,000 pa. This is broadly in line with other spirits companies where we have been able to get specific staff cost disclosure, but significantly ahead of other brewers. On a weighted basis GS's average cost per employee is 10% higher or £5,000, which across 24,000 employees is £110m per annum.

We would expect this to improve as the next phase of development is to staff up emerging market operations with an increasingly higher percentage of local employees which would be at a lower average cost to the start-up employees on ex-pat packages. This efficiency will come from the mix of employees rather than headcount reduction.

Production efficiency

The average price achieved by the spirits & wine companies might well be higher than the brewers but the cost of the product is also higher. Again this is distorted by the much higher production and raw material costs associated with Cognac.

- GS's cost of goods, excluding beer, is £1.57 per litre compared to the average, excluding luxury brands, of £1.97 per litre so GS benchmarks as efficient in its spirits business.

- GS's average COGS per litre for brewing is 48p compared to 36p across its peers because its brewing operations lack the scale of the market leaders.

In brewing scale is very important in driving efficiency. There is a very clear benefit to scale, but one which diminishes above 20 billion litres, the difference being £0.25 COGS per litre as against £0.50 per litre. In this context GS's beer business with only two billion litres is going to be constrained by its scale in driving much more efficiency.

GS's beer does not operate in isolation from the spirits business, which will help in procurement but with a total group volume of four billion litres its buying power will be less pronounced than brewer ABInBev with 40 billion litres of production. To put this into context, GS's total costs of goods bill came to £4bn in FY11, compared to £11bn at ABInBev.

However, scale aside, there is scope for GS to improve the brewing efficiency of its older breweries.

If GS were to close the gap by 25% to its peers this would result in a £70m improvement in its brewing profitability, or three percentage points of additional brewing margin, or 70bp benefit at the group level.

Un-aged grain-based products such as vodka and gin will be more exposed to fluctuations in the commodity and glass pricing cycle than aged scotch whisky. That said, the higher gross margins in spirits help protect against this more efficiently as the commodity-driven price increases are less significant to the retail price.

We are confident that with the focus on premium, improved pricing power in the US and the positive mix effect from faster growth in Scotch, that GS can grow its average selling prices at a faster rate than its cost of goods inflate, which with positive volumes pulling through natural operating leverage, bodes well for continued gross margins expansion.

We forecast that gross margins can continue to recover by 30-40bp per annum back to the level in 2003 before the group embarked on the significant investment in manufacturing, route-to-market and other overheads to support growth.

Figure 19: Gross margins returning to 2003 levels

GS gross margin

Building brands

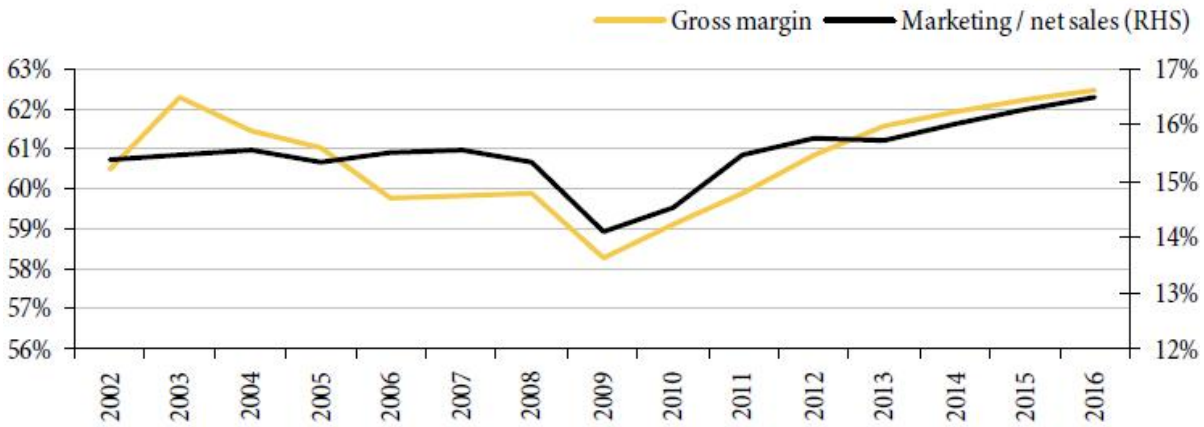
Another area where scale plays an important role is in advertising and promotional expenditure. Here we have had to make an assumption for the amount being spent on beer, but assuming 12% of net sales in line with the peers, leaves GS spending 16.5% of net sales on its spirits & wine brands, which is also in line with the average of the companies we have looked at. Marketing spend is very much in line with peers (17% of net sales for spirits and 12% of net sales for beer).

We do not regard marketing expenditure as a source of natural operating leverage: as discussed earlier heritage brands need to be kept current and this costs money.

In our model we assume the gross margin expansion driven by volume growth after a period of above-trend investment, coupled with mix improvements and some efficiency gains, helps fund increased marketing investment as a percentage of net sales.

Figure 20: The virtuous circle of marketing funded from gross not operating margins

GS gross margin and marketing to net sales



Building the platform for natural operating leverage
Finally, on our way down the P&L we come to structural costs, in other words: costs that cannot be directly attributed to brands, such as sales people who sell a portfolio of products and the general and administrative costs required to run the enterprise.

Here GS benchmarks well against its peers, since we are confident that the necessary sales and support investment has been sunk into the business. We expect further incremental investment to go into China and India, but overall the group should continue to enjoy leverage into its fixed costs investments.

Although ongoing efficiency will be a focus for the group, it is not obvious to us where there is incremental cost savings beyond the £80m benefit from the operating model review as discussed. There is some scope to improve production efficiency in the beer business, but overall after this benchmarking analysis GS appears to be a relatively efficient business.

The continued growth in GS's operating margins has to come from the far more powerful and valuable levers of volume growth, improved mix, expanding gross margins and the natural operating leverage into top-line growth. Delivery of this would help support a continued re-rating as the perceptions of the 'old GS' which could never quite deliver on the promised returns fade. This is not GS moving into unknown territory – it has been charted by the Cognac producers to great effect, and it is time for the Scotch industry to follow.

Operating leverage, everywhere
After FY12 we forecast operating margin improvements in all regions as GS enjoys *natural* operating leverage in the emerging markets and North America, while in Europe margins benefit from the residual operating model cost savings discussed.

After seven years of a frustrating lack of operating leverage GS is finally set to expand margins and break through the hitherto unassailable 30% level. The company's medium-term target is for 200bp of operating margin expansion by FY14, which implies 31%. Our forecast is 100bp ahead of this at 32%.

2.7 GS Management

Management better aligned
A final point to discuss is that historically GS has under-delivered on several organic growth targets. We have discussed how this has been partly due to external factors that derailed the RTD story in 2002/03 or macro factors such as the Global Financial Crisis in 2009/10 or indeed a prolonged period of route-to-market over the period 2003/10; but we can't get away from the fact that GS has previously overpromised and under-delivered.

Our analysis of the operating model encourages us that the necessary building blocks are in place for GS to finally deliver on the promise of sustained double-digit earnings growth, as befits its portfolio. What gives us extra confidence is that both operating and executive management are much more closely aligned to the medium- term operating targets we have been testing.

- There is a greater degree of performance-related pay directly driven by a manager's immediate 'line-of-sight' responsibilities. While this may seem like common sense, previously managers were in part remunerated by their direct performance but equally by the regional or group performance vs targets. The new model has created greater individual responsibility for delivering targets.

- At the executive level the EPS hurdle rates for the performance test on share options has been increased from 3-7% to 6-10%, with 25% vesting at 6% increasing to 100% at 10%.

- In addition performance-related share awards for the executive are now determined by three equally weighted factors: TSR performance against a peer group of companies, previously the only measure used; an organic net sales growth target; and an organic operating margin target.

The GS executive is finally linked into the medium-term targets that have been communicated to the market. It is this, combined with a reinvigorated performance driven culture within the operations, which reassures us that GS is finally poised to deliver.

GS has the powerful combination of a leading brand portfolio and a significantly enhanced route-to-market to ensure these brands deliver on their potential. This combination should support sustained outperformance over the medium term, exceeding the company's medium-term margin targets driven by the return of *natural* operating leverage.

2.8 Global Beer Market Summary

Volume

We estimate that the global beer market represented approximately 1.85 billion hectolitres in 2010. Global beer volume growth continues to be driven by emerging markets, which accounted for virtually all the incremental volume consumption in the last decade. In particular, the most dynamic regions have been Asia Pacific and Africa/Middle East, which have seen the highest real GDP growth. As we have outlined in prior research, in most early and mid-stage developing markets, beer is a first affordable luxury and there is still plenty of room to trade up from cheap local alternatives.

Revenue

We estimate that the global beer market had net revenue of approximately $160 billion in 2010, or approximately $86 per hectolitre of beer. This blended unit pricing includes huge regional disparities, from our estimated $118/hectolitre in North America to $63/hectolitre in Asia Pacific, and indeed huge disparities within regions varying from $33/hectolitre in China to $240/hectolitre in Japan. Broadly speaking, unit pricing is a function of relative GDP per capita and market structure (ie pricing power), with an ideal structure for a brewer of concentrated supply base and fragmented retailers.

EBIT

We estimate that the global beer market had EBIT of approximately $31.5 billion

in 2010 (approximately 20% margin). Similar to revenue, this blended global weighted average hides a number of big differences between regions (from 30% in C&S America to 13% in Asia Pacific) and within regions (eg from 6% in China to 34% in Australia). Broadly speaking, individual market margins seem to be driven by a combination of net price/hectolitre, market structure and brewer efficiency.

Regional Markets Summary

North America accounts for 18% of global beer consumption, but 32% of EBIT. Beer volumes have grown slightly over the last decade, driven by mildly positive demographic trends, mainly population growth. With a strong beer culture and favourable market structure, North America benefits from relatively high unit pricing and high margins.

Latin America accounts for 13% of global beer consumption, but 21% of EBIT. Beer volumes have grown rapidly over the last decade, driven by strong economic development and positive demography. Many markets across the region are organised as virtual monopolies or duopolies with strong dominant players such as AmBev and SAB. As a result, margins are very high across the region, despite relatively modest price/hectolitre.

Western Europe accounts for 15% of global beer consumption, but only 12% of EBIT. Beer volumes have declined over the last decade as a result of negative demographic trends and lower per capita consumption. Markets are more often than not fragmented and competitive, leading to overall lower margins by global standards, despite relatively high selling prices. However, many of the region's brewers are undertaking significant cost-cutting programmes.

Central and Eastern Europe accounts for 14% of global beer consumption, but only 10% of EBIT. Beer volumes have grown rapidly over the last decade, fuelled by strong economic development. However, as is the case for Western Europe, most local markets are strongly competitive (albeit retailer power is much lower), leading to low pricing power and relatively low margins by global standards. These have been compounded by recent specific market issues related to duty and raw materials in the region's biggest market, Russia.

Asia Pacific is the largest regional beer market, accounting for 35% of global beer consumption but only 17% of EBIT. As in other emerging markets, beer volumes have grown rapidly due to a combination of favourable demography and strong economic development. China is by far the largest market but it is also very fragmented, leading to low selling prices/hectolitre and low margins, which drag down the overall region.

Africa/Middle East accounts for only 6% of the global beer consumption and 8% of EBIT. Volumes have grown rapidly over the last decade (off a very low per-capita base), due to favourable demography and continuing economic development. In contrast to many large Asian beer markets, most African markets are structured as oligopolies, leading to high margins by global standards, despite relatively low selling prices.

Figure 21: Significant Disparities in Regional Dynamics

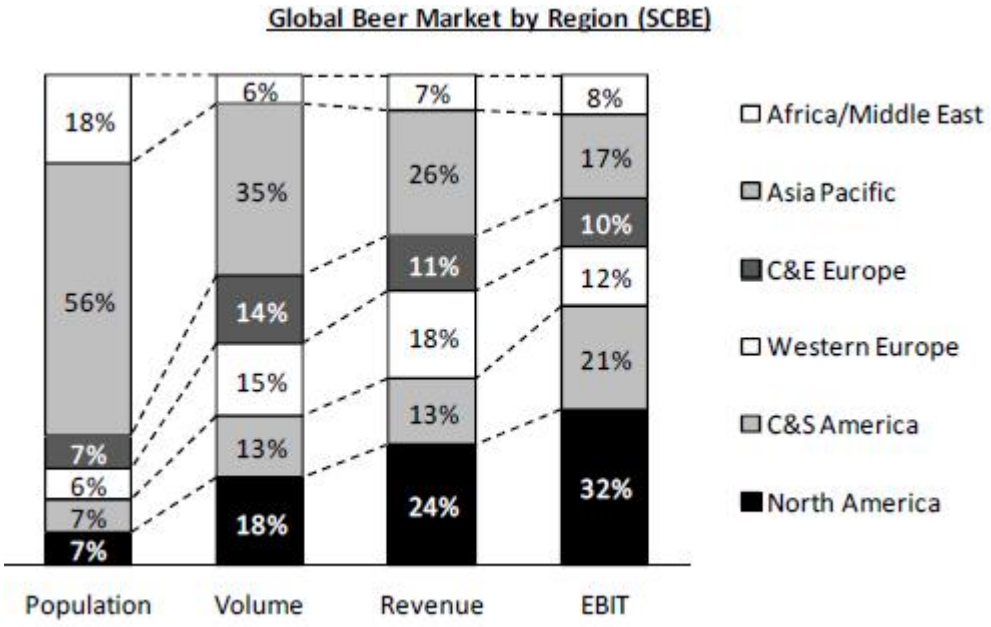
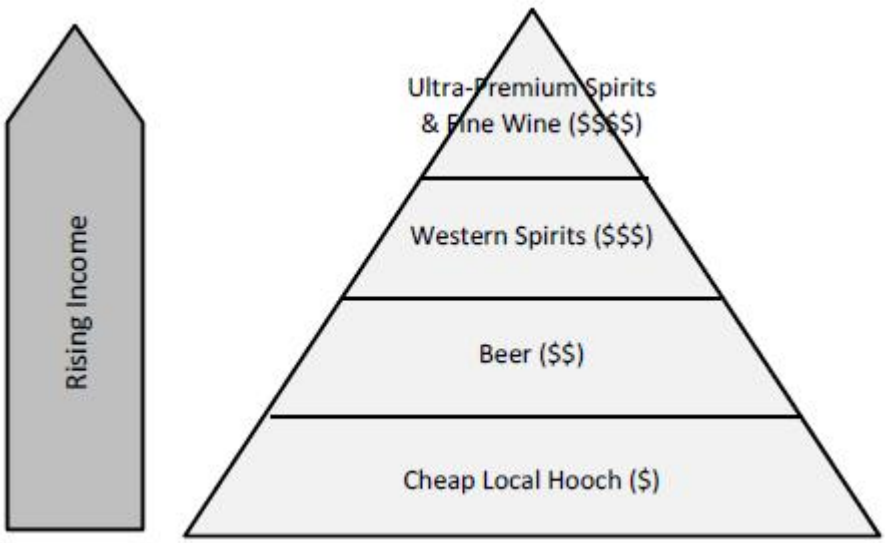


Figure 22: Hierarchy of Needs



3.0 Opinions on GS Equity versus Peers

3.1 Analyst A - Global Spirits Strength and Raised Margin Expectations

Our initial GS Underweight rating was premised on two ideas. First, we believed that the company's margin promises (200bp of expansion in three years) were too optimistic considering the company's lacklustre history of margin delivery. A failure to deliver against those promises would result in another downward earnings revision cycle. Second, we were unsure if GS's key US market would recover quickly enough to support the company's ambitious margin guidance.

Our preference was, and remains, Spiritueux Forts due to SF's higher penetration of super-premium brands, opportunity for balance sheet deleveraging and clearer and more direct China strategy. We believed this structural difference would allow SF shares to outperform GS in both the short and longer term.

We still hold to this thesis, and SF has outperformed GS since our launch of coverage in September of last year. However, we now believe the fundamentals for GS, especially with a US recovery, are too strong to hold on to an Underweight rating.

We are now upgrading GS for two central reasons:

First, we believe that spirits continue to prove resilient globally, even in light of the crisis in Europe, and the industry's strong fundamentals are not consistent with an Underweight rating. Recent results from GS's main competitors, US First Whiskey continue to demonstrate the category's strength in emerging markets and in the key US market. US First Whiskey reported double-digit sales in the calendar 1Q12, with double-digit growth in North America and all other markets. Yankee Spirits reported 10% organic growth in calendar 1Q12, also with highly favourable forward-looking language.

Additionally, from our recent US trade tour, it was clear from talking to the trade that spirits continue to take share from a growing beer category with vodka and American Whiskey the stand out categories. Although price increases have been tame in recent years, especially in vodka, there appears to be room to raise prices in the market without a significant hit to volumes or market share within US beverage alcohol. GS sources 40% of its profits from the US and we think it will continue to benefit from this tailwind.

- As a result, we are raising our top line sales expectations to +7% from +6.4% organic in FY11/12E, +5.5% organic from +5.2% in FY12/13E and to +5% organic from +4% in FY13/14E.

Second, after years of limited EBIT margin growth, we were not initial believers in the margin promises made by the company. However, after the CFO's strong and clear presentation in New York last November and the following 60bp of organic margin expansion in FY11H2, we have moderated our stance and are giving the company more credit for better margin execution. Additionally, our

recent conversation with the company has alleviated some of our scepticism that the company is making promises that it cannot keep.

- We are raising our FY11/12E EBIT margin target to 29.1% from 29% but our FY12/13E margin target is raised to 29.9% from 29.5% and our FY13/14E target is raised to 30.2% from 29.8%.

Portfolio manager's summary
We upgrade GS to Buy from Neutral and increase our target price to 1,840p. We retain our Buy rating on SF. We retain our Neutral rating on Camue Delamy and Yankee Spirits and retain our Reduce on US First Whiskey.

Although the major spirits stocks have seen some rerating in the past few months, we believe that consensus estimates still under-appreciate the potential profit growth rate, especially for SF and GS. Our assessment of the premiumisation opportunity, combined with our updated profit pool analysis, gives us confidence with our EPS estimates for the next three years, which are ahead of the street (SF three-year CAGR 16% versus street 13%, GS 14% versus street 12%).

3.2 Analyst B - Turning more positive on spirits

Summary of rating, target price and earnings changes

Issuer	Rating		Target Price			FY1E EPS		FY2E EPS	
	Old	New		Old	New	Old	New	Old	New
US First Whiskey	Reduce	Reduce	USD	46.0	52.00	2.28	2.28	2.58	2.6
Yankee Spirits	Neutral	Neutral	USD	84.0	88.00	3.88	3.88	4.24	4.25
GS	Neutral	Buy	STG	1500	1840	91.7	91.7	99.9	102.7
Camue Delamy	Neutral	Neutral	EUR	80.00	87.00	3.37	3.37	3.8	4.0
Spiritueux Forts	Buy	Buy	EUR	93.00	104.00	4.66	4.66	5.44	5.53

Note: FY1E = first forecast year, FY2E = second forecast year

Taking profit pool analysis to the next level
Historically, we have analysed the growth potential of the spirits profit pool by applying GDP growth together with the demographic profile for each region. We then calculated an embedded profit growth rate for all the companies under our coverage based on the profit pool work. In this report we develop a medium-term profit growth model for each company, based on the profit pool analysis, adjusted for a premiumisation index that assesses how premium the portfolios of each company are. Simplistically, we believe that the more premium the portfolio, the more opportunity to gain value share.

The table below shows how we have built up our medium-term profit growth model for each company.

Company	Profit Pool Growth	Premiumisation Index	Other Adjustments	Adjusted Profit Pool growth rate
GS	6.6%	2.6%	0.0%	9.2%
SF	8.8%	2.7%	0.0%	11.5%
Yankee Spirits	6.0%	3.1%	0.0%	9.1%
US First Whiskey	4.7%	1.7%	0.0%	6.4%
Spiritueux Forts	8.7%	5.5%	-2.0%	12.2%

Our premiumisation index has been derived from an in-depth study of each company's portfolio by category where we have used industry-based definitions to derive an objective assessment of premiumisation for each company.

3.3 Analyst C – Equity Estimates (2012-2014)

The following table gives a typical set of brokers' estimates of key shareholder metrics through to 2014.

Financials and valuation				Year end:	30 June
	2010A	2011A	2012E	2013E	2014E
Revenue (£m)	9,780	9,936	10,779	11,514	12,303
EBITDA (£m)	3,123	3,236	3,566	3,963	4,261
EBITA (£m)	2,751	2,884	3,200	3,502	3,799
PBT (normalised) (£m)	2,431	2,663	3,016	3,370	3,750
Net Income (normalised) (£m)	1,794	2,083	2,348	2,636	2,943
EPS (normalised & continuing) - FD (p)	72.0	83.4	93.9	105.4	117.7
FCFPS - FD (p)	87.3	73.4	81.3	100.7	112.0
DPS (p)	38.1	40.4	42.8	45.4	48.1
PE (normalised) (x)	21.8	18.8	16.7	14.9	13.3
EV/sales (x)	4.7	4.6	4.3	4.0	3.7
EV/EBITDA (x)	14.8	14.2	12.9	11.6	10.8
FCF yield (%)	5.6	4.7	5.2	6.4	7.1
Dividend yield (%)	2.4	2.6	2.7	2.9	3.1

4.0 Finance and Treasury

4.1 Capital Structure and Targeted Credit Rating

The group's management is committed to enhancing shareholder value in the long term, both by investing in the businesses and brands so as to improve the return on investment and by managing the capital structure. GS manages its capital structure to achieve capital efficiency, maximise flexibility and give the appropriate level of access to debt markets at attractive cost levels. This is achieved by targeting a range of ratios which are currently broadly consistent with an A band credit rating. GS would consider modifying these ratios in order to effect strategic initiatives within its stated goals, which could have an impact on its rating.

4.2 Summary of Debt and Cash by Currency (2011)

GS: Debt (Issuance and 2011) & CASH by CURRENCY

CURRENCY	ISSUANCE GBP m	Y/E 2011 AFTER DERIVATIVES GBPm	Y/E 2011 CASH & CASH EQUIVALENTS GBPm
USD	5110	3689	1058
EUR	2609	1990	56
GBP		1776	123
KOREAN WON		174	
OTHER	255	405	347
SUB-TOTAL	7974	8034	1584
ADJUSTMENTS:			
Financial Lease		-79	
FV Borrowings	221		
FV Derivatives	-240		
TOTAL	7955	7955	1584

4.3 Detail of Borrowing and Bank Overdraft

Borrowings and bank overdrafts

	Repayment date	Currency	Year end interest rates %	2011 £ million	2010 £ million
Bank overdrafts	On demand	Various	Various	12	55
Bank and other loans	Various	Various	Various	103	106
Credit support obligations	2011	Various	Various	91	80
Guaranteed debentures 2011	2011	US dollar	9.0	186	–
Guaranteed bonds 2011	2011	US dollar	3.875	–	333
Guaranteed bonds 2012	2012	US dollar	5.125	373	–
Guaranteed bonds 2012	2012	Euro	1.674	675	–
Fair value adjustment to borrowings				7	13
Borrowings due within one year and bank overdrafts				1,447	587
Guaranteed bonds 2012	2012	US dollar	5.125	–	399
Guaranteed bonds 2012	2012	Euro	0.93	–	615
Guaranteed bonds 2013	2013	US dollar	5.2	466	500
Guaranteed bonds 2013	2013	US dollar	5.5	373	400
Guaranteed bonds 2013	2013	Euro	5.5	1,035	941
Guaranteed bonds 2014	2014	US dollar	7.375	502	540
Guaranteed bonds 2014	2014	Euro	6.625	899	818
Guaranteed bonds 2015	2015	US dollar	5.3	465	499
Guaranteed bonds 2015	2015	US dollar	3.25	310	332
Guaranteed bonds 2016	2016	US dollar	5.5	372	399
Guaranteed bonds 2017	2017	US dollar	5.75	775	832
Guaranteed bonds 2020	2020	US dollar	4.828	362	390
Guaranteed bonds 2035	2035	US dollar	7.45	248	267
Guaranteed bonds 2036	2036	US dollar	5.875	369	397
Guaranteed debentures 2011	2011	US dollar	9.0	–	200
Guaranteed debentures 2022	2022	US dollar	8.0	185	198
Medium term notes	2018	US dollar	4.85	124	133
Bank and other loans	Various	Various	Various	49	51
Fair value adjustment to borrowings				214	266
Borrowings due after one year				6,748	8,177
Total borrowings before derivative financial instruments				8,195	8,764
Fair value of foreign currency forwards and swaps	Various	Various	Various	(182)	(227)
Fair value of interest rate hedging instruments	Various	Various	Various	(58)	(191)
Total borrowings after derivative financial instruments				7,955	8,346

Bank overdrafts form an integral part of the group's cash management and are included as a component of net cash and cash equivalents in the consolidated statement of cash flows. All bonds, medium term notes, debentures and commercial paper are fully and unconditionally guaranteed by GS.

Included in borrowings due within one year are credit support obligations. When derivative transactions are undertaken with bank counterparties, the group may where appropriate enter into certain agreements with such bank counterparties whereby the parties agree to post cash collateral for the benefit of the other if the net valuations of the derivatives are above a pre-determined threshold. At 30 June 2011, the collateral held under these agreements amounted to $84 million (£52 million) and €44 million (£39 million) (2010 - $80 million (£54 million) and €32 million (£26 million)).

The interest rates shown in the table above are those contracted on the underlying borrowings before taking into account any interest rate protection. The average monthly net borrowings for the year were £7,227 million (2010 – £7,912 million). Based on average monthly net borrowings and interest charge, taking into account interest rate protection, the effective interest rate for the year was 4.9% (2010 – 4.8%; 2009 – 6.2%). For this calculation, net borrowings exclude interest rate related fair value adjustments and the interest charge excludes finance charges unrelated to net borrowings, the forward element on derivative financial instruments and fair value adjustments to interest rate swaps and borrowings. The loans above are stated net of unamortised finance costs of £78 million (2010 – £84 million : 2009 – £12 million).

The weighted average interest rate, before interest rate protection, for short term borrowings at 30 June 2011 was 4.3% (2010 – 5.6% : 2009 – 6.4%). The weighted average interest rate, before interest rate protection, for bonds, medium term notes and bank loans included within borrowings due after one year at 30 June 2011 was 5.8% (2010 – 5.5% : 2009 – 5.6%).

Certain borrowings are reported in the table above at amortised cost with a fair value adjustment shown separately.

The following summary of the company's debt is based on the last six years published accounts.

Summary of Total Debt, Irrespective of Term

	2006	2007	2008	2009	2010	2011
Bank loans, OD's	239	297	214	280	292	255
Commercial Paper	0	299	783	5	0	0
Debentures	321	296	300	361	398	371
Bonds	2,967	3,883	4,912	7,500	7,662	7,224
MTNs	1,280	916	975	303	133	124
Fair Value Adjustments	(47)	(24)	24	126	279	221
Total	4,760	5,667	7,208	8,575	8,764	8,195

4.3 Detail of Borrowing and Bank Overdraft (cont'd)

(a) Analysis of net borrowings

	2011 £ million	2010 £ million
Bank overdrafts	(12)	(55)
Borrowings due within one year	(1,435)	(532)
Borrowings due after one year	(6,748)	(8,177)
Fair value of foreign currency forwards and swaps	182	227
Fair value of interest rate hedging instruments	58	191
Finance lease liabilities	(79)	(61)
Gross borrowings	(8,034)	(8,407)
Offset by: Cash and cash equivalents	1,584	1,453
Net borrowings	(6,450)	(6,954)

£15 million (2010 – £56 million) of net borrowings due within one year and £26 million (2010 – £24 million) of net borrowings due after one year were secured on assets of the group.

Foreign currency forwards and swaps, interest rate hedging instruments and finance lease liabilities are included as appropriate in other financial assets and other financial liabilities.

(b) Reconciliation of movement in net borrowings

	2011 £ million	2010 £ million
Net borrowings at beginning of the year	(6,954)	(7,419)
Increase in net cash and cash equivalents before exchange	242	568
Net decrease in loans	414	422
Change in net borrowings from cash flows	656	990
Exchange differences on net borrowings	(17)	(429)
Borrowings acquired through acquisition of businesses	(22)	–
Other non-cash items	(113)	(96)
Net borrowings at end of the year	(6,450)	(6,954)

4.4 Net Borrowings Interest Rate Profile

(j) Analysis of cash and cash equivalents by currency

	2011		2010	
	£ million	%	£ million	%
US dollar	1,058	66	844	58
Euro	56	4	118	8
Sterling	123	8	69	5
Other	347	22	422	29
Cash and cash equivalents	1,584	100	1,453	100

(k) Analysis of gross borrowings by currency

	2011		2010	
	£ million	%	£ million	%
US dollar	(3,689)	46	(3,864)	46
Euro	(1,990)	25	(1,840)	22
Sterling	(1,776)	22	(1,690)	20
Korean won	(174)	2	(316)	4
Other	(405)	5	(697)	8
Gross borrowings	(8,034)	100	(8,407)	100

The analysis of group's gross borrowings above includes the impact of foreign currency forwards and swaps.

(l) Analysis of net borrowings by interest rate profile

	2011		2010	
	£ million	%	£ million	%
Fixed rate	(3,752)	58	(3,391)	49
Floating rate	(2,722)	42	(3,766)	54
Interest free	5	–	64	(1)
Impact of financial derivatives and fair value adjustments	19	–	139	(2)
Net borrowings	(6,450)	100	(6,954)	100

The split of fixed and floating rate net borrowings above includes the impact of interest rate hedging instruments.

4.5 Estimated Funding Required Per Year to 2016

GLOBAL SPIRITS
2011

	2007	2007-11	2011	2012	2013	2014	2015	2016
	GBP m		GBP m	GBP m	GBP m	GBP m	GBP m	GBP m
	Actual		Actual					
Sales Revenue (Assume CAGR 7% from Base Yr)	7481	CAGR 7%	9936 Base Yr	10631 Estimate	11377	12173	13025	13926
Gross Debt Required (Assume CAGR 7% from Base Yr)	5667	CAGR 10%	8195 Base Yr	8769 Estimate	9382	10039	10741	11494
Funding Required per annum				2026 Estimate	1486	2211	1931	1235

To estimate the magnitude of funding required over the five years to 2016 it is assumed that the historical level of growth is maintained. Sales revenue CAGR from 2007 to 2011 was 7% per annum. Gross debt CAGR over the same period was 10%.

The Sales Revenue & Gross Debt estimates for 2012 – 2016 are both based on a CAGR of 7% from the base year 2011.

The Estimated Funding Required per annum. is based on the estimated Incremental Gross Debt in the table above plus maturing borrowings, finance lease liabilities and credit support obligations.

4.6 Treasury Risk Management

Derivative financial instruments are used to hedge exposure to fluctuations in foreign exchange rates, interest rates and commodity price movements that arise in the normal course of the group's business.

The group's funding, liquidity and exposure to foreign exchange rate and interest rate risks are managed by the group's treasury department. The treasury department uses a range of financial instruments to manage these underlying risks.

Treasury operations are conducted within a framework of board-approved

policies and guidelines, which are recommended and subsequently monitored by the finance committee. This committee is described in the Corporate governance report. These policies and guidelines include benchmark exposure and/or hedge cover levels for key areas of treasury risk. The benchmarks, hedge cover and overall appropriateness of GS's risk management policies are reviewed by the board following, for example, significant business, strategic or accounting changes. The framework provides for limited defined levels of flexibility in execution to allow for the optimal application of the board-approved strategies. Transactions arising on the application of this flexibility may give rise to exposures different from the defined benchmark levels that are separately monitored on a daily basis using value at risk analysis. These transactions are carried at fair value and gains or losses are taken to the income statement as they arise. In the year ended 30 June 2011 gains and losses on these transactions were not material.

The finance committee receives monthly reports on the activities of the treasury department, including any exposures different from the defined benchmarks.

(a) Currency risk The group publishes its consolidated financial statements in sterling and conducts business in many foreign currencies. As a result, it is subject to foreign currency exchange risk due to exchange rate movements, which will affect the group's transactions and the translation of the results and underlying net assets of its foreign operations. To manage the foreign exchange risk the group's treasury department uses certain financial instruments. Where hedge accounting is applied, hedges are documented and tested for hedge effectiveness on an ongoing basis. GS expects hedges entered into to continue to be effective and therefore does not expect the impact of ineffectiveness on the consolidated income statement to be material.

Hedge of net investment in foreign operations The group hedges a substantial portion of its exposure to fluctuations in the sterling value of its foreign operations by designating net borrowings held in foreign currencies and by using foreign currency spots, forwards, swaps and other financial derivatives. The board reviewed and approved a revised policy, applicable from 3 December 2010, to manage hedging of foreign exchange risk arising from net investment in foreign operations. The group's revised policy is, where a liquid foreign exchange market exists, to seek to hedge currency exposure on its net investment in foreign operations by using gross debt in foreign currencies and foreign currency spots, forwards, swaps and other financial derivatives within the following percentage bands: 80% to 100% for US dollars and euros and, at management's discretion, 0% to 100% for other currencies. The group's previous policy where a liquid foreign exchange market existed, was to aim to hedge currency exposure on its net investment in foreign operations by using net debt in foreign currencies and foreign currency spots, forwards, swaps and other financial derivatives and within the following percentage bands: 80% to 100% for US dollars and euros and 50% to 100% for other currencies. As at 30 June 2011, these ratios were 89% and 87% for US dollars and euros, respectively, and 42% for other currencies.

Exchange differences arising on the retranslation of foreign currency borrowings (including foreign currency forwards, swaps and other financial derivatives), to

the extent that they are in an effective hedge relationship, are recognised in other comprehensive income to offset exchange differences on net investments in foreign operations. Exchange differences on foreign currency borrowings not in a hedge relationship and any ineffectiveness are taken to the income statement.

Transaction exposure hedging The board reviewed the group's transactional foreign exchange risk management policy and approved a revised policy, on 1 October 2010. The group's revised policy is to aim to hedge 18 months forecast transactional foreign exchange rate risk in the three major currency pairs (US dollar/sterling, euro/sterling and euro/US dollar), up to 100%, with a target range of between 75% and 100% once the relevant annual plan has been approved. In addition, at management's discretion, the group may decide to hedge other currencies for up to 18 months. The group's previous policy was to seek, for currencies in which there was an active market, to hedge between 60% and 100% of forecast transactional foreign exchange rate risk, for up to a maximum of 21 months forward, using foreign currency forward contracts with coverage levels increasing nearer to the forecast transaction date. The effective portion of the gain or loss on the hedge is recognised in other comprehensive income and recycled into the income statement at the same time as the underlying hedged transaction affects the income statement. Any ineffectiveness is taken to the income statement.

Hedge of foreign currency debt The group uses cross currency interest rate swaps to hedge the foreign currency risk associated with certain foreign currency denominated borrowings. The effective portion of the gain or loss on the hedge is recognised in other comprehensive income and recycled into the income statement at the same time as the underlying hedged transaction affects the income statement. Any ineffectiveness is taken to the income statement.

Quantitative analysis of the sensitivity to movements in currency rates is reported in the table in (d) Market Risk Sensitivity Analysis.

(b) Interest rate risk The group has an exposure to interest rate risk, arising principally on changes in US dollar, euro and sterling interest rates. To manage interest rate risk, the group manages its proportion of fixed to floating rate borrowings within limits approved by the board, primarily through issuing fixed and floating rate borrowing and commercial paper, and by utilising interest rate derivatives. These practices aim to minimise the group's net finance charges with acceptable year on year volatility. To facilitate operational efficiency and effective hedge accounting, the group's policy is to maintain fixed rate borrowings within a band of 40% to 60% of forecast net borrowings. For these calculations, net borrowings exclude interest rate related fair value adjustments. A template approved by the board specifies different duration guidelines and fixed/floating amortisation periods (time taken for the fixed element of debt to reduce to zero) depending on different interest rate environments. The majority of GS's existing interest rate derivatives are designated as hedges and are expected to be effective. Fair value of these derivatives is recognised in the income statement, along with any changes in the relevant fair value of the underlying hedged asset or liability.

(c) Commodity price risk The group is exposed to commodity price risk. The group primarily uses long term purchase contracts to secure prices with suppliers to protect against volatility in commodity prices.

(d) Market risk sensitivity analysis The group is using a sensitivity analysis technique that measures the estimated impacts on the consolidated income statement and other comprehensive income of either an instantaneous increase or decrease of 0.5% (50 basis points) in market interest rates or a 10% strengthening or weakening in sterling against all other currencies, from the rates applicable at 30 June 2011 and 30 June 2010, for each class of financial instruments with all other variables remaining constant. The sensitivity analysis excludes the impact of market risks on the net post-employment benefit liability and corporate tax payable. This analysis is for illustrative purposes only, as in practice interest and foreign exchange rates rarely change in isolation.

The sensitivity analysis is based on the following:

- Financial instruments are valued at the balance sheet date using discounted cash flow techniques
- Changes in interest rates affect the interest income or expense of variable interest financial instruments
- Changes in interest rates only affect interest income or expense in relation to financial instruments with fixed interest rates if these are recognised at fair value
- Changes in interest rates affect the fair value of derivative financial instruments designated as hedging instruments
- Changes in the fair values of derivative financial instruments and other financial assets and liabilities are estimated by discounting the future cash flows to net present values using rates prevailing at the year end
- All interest rate, net investment and foreign currency cash flow hedges are expected to be highly effective

The sensitivity analysis estimates the impact of changes in interest and foreign exchange rates. Actual results in the future may differ from these results materially due to developments in the global financial markets which may cause fluctuations in interest and exchange rates to vary from the hypothetical amounts disclosed in the following table, which therefore should not be considered as projections of likely future events, gains or losses.

Reasonably possible hypothetical changes in other risk variables would not significantly affect the fair value of financial instruments at 30 June 2011 and 30 June 2010.

Financial instruments and risk management

Analysis of sensitivities

	0.5% decrease in interest rates £ million	0.5% increase in interest rates £ million	10% weakening of sterling £ million	10% strengthening of sterling £ million
2011				
Impact on income statement – gain/(loss)	13	(13)	(29)	24
Impact on the consolidated statement of comprehensive income – gain/(loss)[a] [b]	22	(22)	(731)	598
2010				
Impact on income statement – gain/(loss)	19	(19)	(33)	27
Impact on the consolidated statement of comprehensive income – gain/(loss)[a] [b]	34	(33)	(739)	605

(a) The group's foreign currency debt is used as a hedge of net investments in foreign operations and as such the translation of foreign net investments would mainly offset the foreign currency gains or losses on financial instruments recognised in other comprehensive income.

(b) Impact on the consolidated statement of comprehensive income includes the impact on the income statement.

The above analysis considers the impact of all financial instruments including financial derivatives, cash and cash equivalents, borrowings and other financial assets and liabilities.

(e) Credit risk Credit risk refers to the risk that a counterparty will default on its contractual obligations resulting in financial loss to the group. Credit risk arises from cash balances (including bank deposits and cash and cash equivalents), derivative financial instruments and credit exposures to customers, including outstanding loans, trade and other receivables, financial guarantees and committed transactions. Credit risk is managed separately for financial and business related credit exposures.

Financial credit risk GS aims to minimise its financial credit risk through the application of risk management policies approved and monitored by the board. Counterparties are limited to major banks and financial institutions and the policy restricts the exposure to any one counterparty by setting credit limits taking into account the credit quality of the counterparty. The group's policy is designed to ensure that individual counterparty limits are adhered to and that there are no significant concentrations of credit risk. The board also defines the types of financial instruments which may be transacted. Financial instruments are primarily transacted with major international financial institutions with a long term credit rating within the A band or better. The credit risk arising through the use of financial instruments for interest rate and currency risk management is estimated with reference to the fair value of contracts with a positive value, rather than the notional amount of the instruments themselves.

When derivative transactions are undertaken with bank counterparties, GS may, where appropriate, enter into certain agreements with such bank counterparties

whereby the parties agree to post cash collateral for the benefit of the other if the net valuations of the derivatives are above a pre-determined threshold.

GS annually reviews the credit limits applied and regularly monitors the counterparties' credit quality reflecting market credit conditions.

Business related credit risk Trade and other receivables exposures are managed locally in the operating units where they arise and credit limits are set as deemed appropriate for the customer. There is no concentration of credit risk with respect to trade and other receivables as the group has a large number of customers which are internationally dispersed.

The maximum credit risk exposure of the group's financial assets was as follows:

	2011 £ million	2010 £ million
Trade and other receivables (excluding taxes)	1,751	1,825
Accrued income	23	31
Assets held for sale	9	13
Cash and cash equivalents	1,584	1,453
Derivative financial assets	200	334
Other investments	102	117
Total	3,669	3,773

Derivative financial assets comprise the fair value of derivatives receivable from financial institutions partly offset by cash collateral received.

Cash and cash equivalents comprise cash in hand and deposits which are readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value and have an original maturity of three months or less at acquisition including money market deposits, commercial paper and investments.

At 30 June 2011, approximately 13% and 17% of the group's trade receivables of £1,501 million are due from counterparties based in the United Kingdom and in the United States, respectively.

(f) Liquidity risk Liquidity risk is the risk that GS may encounter in meeting its obligations associated with financial liabilities that are settled by delivering cash or other financial assets. The group's policy with regard to the expected maturity profile of borrowings is to limit the amount of such borrowings maturing within 12 months to 50% of gross borrowings less money market demand deposits, and the level of commercial paper to 30% of gross borrowings less money market demand deposits. In addition, it is group policy to maintain backstop facility terms from relationship banks to support commercial paper obligations.

Maturity of cash flows for financial liabilities by year of repayment

	Bank loans and overdrafts £ million	Other borrowings £ million	Interest on borrowings £ million	Interest rate swaps £ million	Credit support obligations £ million	Finance lease liabilities £ million	Other £ million	Total £ million
2011								
After five years	–	(2,512)	(1,081)	9	–	(76)	(7)	(3,667)
From four to five years	(9)	(466)	(161)	(5)	–	(7)	(1)	(649)
From three to four years	(9)	(1,212)	(244)	(7)	–	(8)	(1)	(1,481)
From two to three years	(9)	(1,534)	(338)	(14)	–	(11)	(4)	(1,910)
From one to two years	(22)	(839)	(385)	(14)	–	(12)	(40)	(1,312)
Due after one year	(49)	(6,563)	(2,209)	(31)	–	(114)	(53)	(9,019)
Due within one year	(115)	(1,234)	(438)	(13)	(91)	(12)	(2,140)	(4,043)
	(164)	(7,797)	(2,647)	(44)	(91)	(126)	(2,193)	(13,062)
2010								
After five years	(7)	(3,198)	(1,335)	(5)	–	(80)	(8)	(4,633)
From four to five years	(31)	(1,153)	(254)	(2)	–	(5)	(1)	(1,446)
From three to four years	(4)	(1,478)	(346)	(7)	–	(7)	(22)	(1,864)
From two to three years	(4)	(900)	(394)	(8)	–	(8)	(8)	(1,322)
From one to two years	(5)	(1,215)	(435)	(9)	–	(8)	(86)	(1,758)
Due after one year	(51)	(7,944)	(2,764)	(31)	–	(108)	(125)	(11,023)
Due within one year	(161)	(333)	(461)	(8)	(80)	(8)	(2,079)	(3,130)
	(212)	(8,277)	(3,225)	(39)	(80)	(116)	(2,204)	(14,153)

Other financial liabilities primarily consist of trade payables and foreign currency forwards and swaps. Amounts are shown on an undiscounted basis. Where interest payments are on a floating rate basis, rates of each cash flow until maturity of the instruments are calculated based on the forward yield curve at the last business day of the years ended 30 June 2011 and 30 June 2010. Finance lease liabilities at 30 June 2011 of £126 million include interest of £47 million (2010 – finance lease liabilities of £116 million including interest of £55 million).

The group had available undrawn committed bank facilities as follows:

	2011 £ million	2010 £ million
Expiring within one year	776	920
Expiring between one and two years	727	833
Expiring after two years	671	780
	2,174	2,533

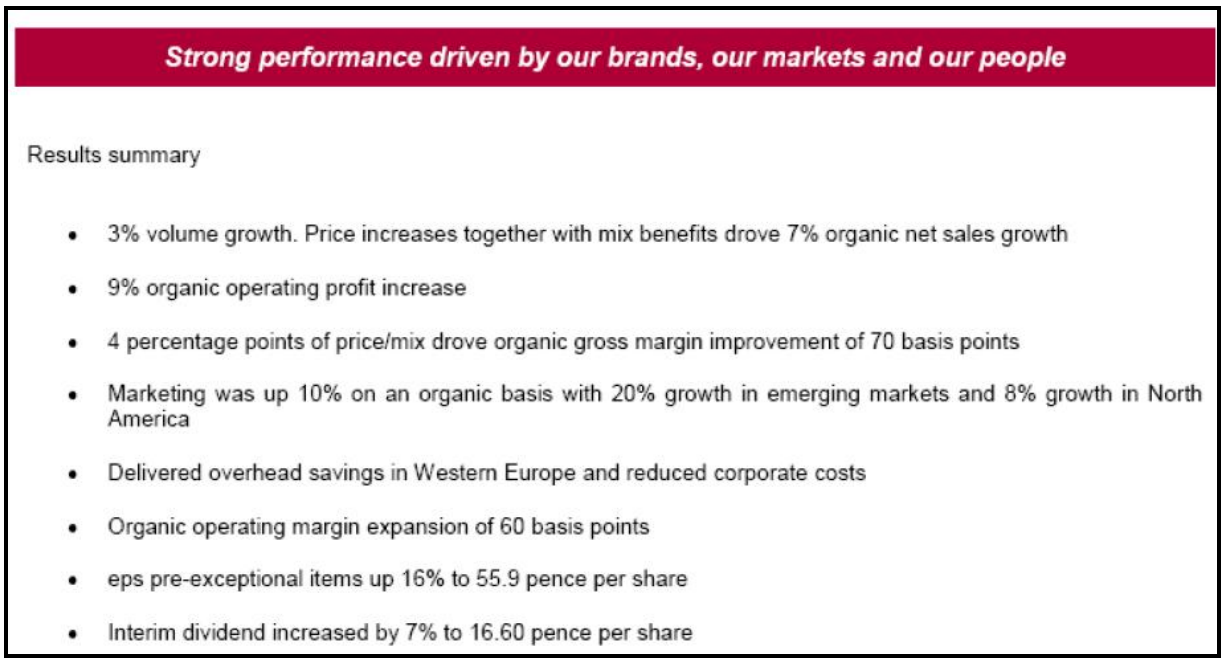
Commitment fees are paid on the undrawn portion of these facilities and accounted for on an accruals basis. Borrowings under these facilities will be at prevailing LIBOR rates (dependent on the period of drawdown) plus an agreed margin. These facilities can be used for general corporate purposes and, together with cash and cash equivalents, support the group's commercial paper programmes.

There are no financial covenants on the group's short and long term borrowings. Certain of these borrowings contain cross default provisions and negative pledges. The committed bank facilities are subject to a single financial covenant, being minimum interest cover ratio of two times (defined as the ratio of operating profit before exceptional items, aggregated with share of associates' profits after tax, to net interest). They are also subject to pari passu ranking and negative pledge covenants.

Any non-compliance with covenants underlying GS's financing arrangements could, if not waived, constitute an event of default with respect to any such arrangements, and any non-compliance with covenants may, in particular circumstances, lead to an acceleration of maturity on certain notes and the inability to access committed facilities. GS was in full compliance with its financial, pari passu ranking and negative pledge covenants throughout each of the years presented.

4.7 Interim 2012

GS Half year results, six months ended 31 December 2011



5.0 Financials

- Income Statement
- Balance Sheet
- UK-Style Cash Flow Statement
- Share Price Data & Equity Analysis
- Cash Flow Analysis
- Financial Profile

Equity Analysis Model
Global Spirits plc
Income Statement

			Historical Data					Interim
Month		*Accounts date*	2007	2008	2009	2010	2011	2012
June		*Currency / units*	£mill	£mill	£mill	£mill	£mill	£mill
		Audit / man / fcst	audited	audited	audited	audited	audited	audited
		Number of months	12	12	12	12	12	6
Sales Revenue			**7,481**	**8,090**	**9,311**	**9,780**	**9,936**	**5,757**
a	(Cost of Sales)		(3,003)	(3,245)	(3,893)	(4,099)	(4,010)	(2,189)
a	**Gross Profit**		**4,478**	**4,845**	**5,418**	**5,681**	**5,926**	**3,568**
	(Marketing Costs)		(1,162)	(1,239)	(1,327)	(1,419)	(1,538)	(896)
a	(Other Overheads)		(1,196)	(1,311)	(1,731)	(1,571)	(1,627)	(806)
a	Other Operating (Costs) & Revenues				34	45	17	
a	Exceptionals etc. +/-		39	(69)	24	(162)	(183)	(24)
b	Cost of Materials, Other External Purchases							
b	**Value Added**							
b	(Personnel Costs)							
b	(Depreciation & Impairment of Tangible Assets)		(181)	(198)	(223)	(302)	(283)	(168)
b	(Amortisation of Intangibles excluding Goodwill)							
b	(R&D Costs)							
b	Other Operating (Costs) & Revenues							
b	Exceptionals etc. +/-							
Operating Profit			**2,159**	**2,226**	**2,418**	**2,574**	**2,595**	**1,842**
Non-operating Income & Expenditure								
	Exceptionals etc.		(1)	9		(15)	(14)	102
	(Amortisation & Impairment of Goodwill)							
Financial Income								
	Income from Investments, Participations etc		149	177	164	142	176	122
	Other Financial Income & Expenditure		39	22	(76)	(87)	(28)	(22)
EBIT			**2,346**	**2,434**	**2,506**	**2,614**	**2,729**	**2,044**
Interest Received & Paid								
	Interest Received		111	153	252	469	278	91
	(Gross Interest Paid)		(362)	(494)	(768)	(844)	(647)	(275)
Profit before Tax			**2,095**	**2,093**	**1,990**	**2,239**	**2,360**	**1,860**
	(Current tax)		(678)	(522)	(286)	(477)	(343)	(841)
	(Deferred tax)							
Profit after Tax			**1,417**	**1,571**	**1,704**	**1,762**	**2,017**	**1,019**
	Extraordinaries, Discontinued Operations etc		139	26	2	(19)		
	Minority Interests		(67)	(76)	(101)	(114)	(117)	
	(Preference Dividends)							
Net Income / Earnings for Ordinary Shareholders			**1,489**	**1,521**	**1,605**	**1,629**	**1,900**	**1,019**
	(Ordinary Dividends)		(858)	(857)	(870)	(914)	(973)	(414)
Retained Profit for Year			**631**	**664**	**735**	**715**	**927**	**605**
	Statement of Gains and Losses							
Income after gains and Losses			1,556	1,597	1,706	1,743	2,017	1,019

EBITA (before exceptionals & Goodwill Amort.)	**2,308**	**2,494**	**2,482**	**2,791**	**2,926**	**1,966**
EBITDA (before Exceps. Deprn, & all Amortisn.)	**2,489**	**2,692**	**2,705**	**3,093**	**3,209**	**2,134**
Cash Earnings (Before Goodwill, Exceps.& Extraords)	**1,312**	**1,555**	**1,579**	**1,825**	**2,097**	**941**
Cash Retained Profit (Before Goodwill, Exceps & Extraords)	**454**	**698**	**709**	**911**	**1,124**	**527**

Equity Analysis Model
Global Spirits plc
Balance Sheet

	Historical Data					
Accounts date	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Currency / units	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**
Intangible Fixed Assets	4,383	5,530	6,215	6,726	6,545	8,092
Property, Land & Buildings, Forestry Assets - net	709	737	818	746	734	750
Other Fixed Assets - net	1,223	1,385	1,450	1,658	1,818	2,031
Financial Investments, Tax & Pension Assets & Derivative	2,437	2,756	3,390	3,257	3,401	3,583
Medium-term Trade-related Assets	17	11	18	115	118	217
Total Fixed Assets	**8,769**	**10,419**	**11,891**	**12,502**	**12,616**	**14,673**
Stocks, Inventories, Work in Progress	2,465	2,739	3,162	3,281	3,473	3,755
Debtors, Prepayments, Receivables etc.	1,759	2,051	2,031	2,008	1,977	2,843
Cash and Short-term Investments	885	714	914	1,453	1,584	1,121
Tax Assets, Derivatives & Other Current Assets	78	104	98	210	127	54
Total Current Assets	**5,187**	**5,608**	**6,205**	**6,952**	**7,161**	**7,773**
Total Assets	**13,956**	**16,027**	**18,096**	**19,454**	**19,777**	**22,446**
Short-term Debt	1,535	1,663	890	587	1,447	2,741
Creditors, Accruals, Advance Payments etc.	1,888	2,143	2,173	2,615	2,838	3,203
Corporation Tax Payable	673	685	532	391	381	474
Provisions, Derivatives & Other Current Liabilities	103	198	392	351	249	220
Total Current Liabilities	**4,199**	**4,689**	**3,987**	**3,944**	**4,915**	**6,638**
Medium & Long-term Debt	4,132	5,545	7,685	8,177	6,748	6,863
Medium-term Trade-related Liabilities	38	34	30	76	41	48
Deferred Tax, Pension & Other Long-term Provisions	1,417	1,584	2,458	2,471	2,088	2,799
Total Non-current Liabilities	**5,587**	**7,163**	**10,173**	**10,724**	**8,877**	**9,710**
Issued Share Capital				797	797	797
Share Premium Account, Treasury Shares	848	816	797	1,342	1,343	1,343
Revaluation Reserve	1,341	1,342	1,342	3,245	3,300	3,195
Other Reserves	3,186	3,163	3,282	(1,377)	(195)	(202)
Retained Earnings / Profit and Loss	(1,403)	(1,823)	(2,200)			
Total Capital and Reserves	**3,972**	**3,498**	**3,221**	**4,007**	**5,245**	**5,133**
Minority Interests	198	677	715	779	740	965
Total Shareholders' Funds	**4,170**	**4,175**	**3,936**	**4,786**	**5,985**	**6,098**
Balance Check	-	-	-	-	-	-
Accumulated depreciation	1,007	1,149	1,390	1,733	1,974	2,142
Average Cost of Debt %			6.10%	5.30%	5.00%	

Equity Analysis Model

Global Spirits plc

UK-Style Cash Flow Statement

	Historical Data					
Accounts date	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Currency / units	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**
Number of months	**12**	**12**	**12**	**12**	**12**	**6**
CASH FLOW FROM OPERATING ACTIVITIES						
Operating Profit	2,159	2,226	2,418	2,574	2,595	1,842
Tangible Asset Depreciation	181	198	223	302	283	168
Dec(Inc) in Stock / Inventories	(180)	(282)	(236)	(104)	(204)	(210)
Dec(Inc) in Debtors / Receivables			193	69	62	(782)
Inc(Dec) in Creditors / Payables & Advance Payments			(210)	369	30	257
All other non-cash adjustments & Exceptionals	62	113	37	(137)	(25)	(17)
Cash Generated from Operations	**2,222**	**2,255**	**2,425**	**3,073**	**2,741**	**1,258**
Dividends Received from Associates			179	111	138	4
Tax Paid	(368)	(369)	(522)	(474)	(365)	(214)
Net Cash from Operating Activities	**1,854**	**1,886**	**2,082**	**2,710**	**2,514**	**1,048**
CASH FLOW FROM INVESTING ACTIVITIES						
Dividends Received from Investments						
Interest Received	42	67	63	307	213	99
(Purchase of Tangible Fixed Assets)	(274)	(328)	(355)	(374)	(419)	(219)
Disposal of Tangible Fixed Assets	69	66	14	143	47	29
(Purchase of Subs, Intang., Financial & Forestry Assets)	(76)	(575)	(126)	(249)	(117)	(1,492)
Disposal of Subsidiaries, Intangibles & Financial Assets	4	8	1	1	35	8
Net Cash from Investing Activities	**(235)**	**(762)**	**(403)**	**(172)**	**(241)**	**(1,575)**
CASH FLOW FROM FINANCING ACTIVITIES						
(Total Interest Paid)	(279)	(387)	(478)	(612)	(524)	(328)
New Shares Issued	1	1		85	1	11
(Repurchase / Redemption of Shares)	(1,430)	(1,086)	(392)		(9)	(209)
(Costs of Issuing / Redeeming Equity)						
Total Increase in Debt	1,226	1,094	256			1,276
(Total Decrease in Debt)				(422)	(414)	
(Dividends Paid on Ordinary Shares)	(858)	(857)	(870)	(914)	(973)	(621)
(Preference and Minority Dividends Paid)	(41)	(56)	(98)	(107)	(112)	(72)
Movements Relating to Derivative Instruments						
Net Cash from Financing Activities	**(1,381)**	**(1,291)**	**(1,582)**	**(1,970)**	**(2,031)**	**57**
Net Cash Flow from Ops. Investing & Funding	238	(167)	97	568	242	(470)
Balance check	-	-	-	-	-	-
Change in Cash	-	(171.0)	200.0	539.0	131.0	(463.0)
Change in Overdraft	238.0	4.0	(103.0)	29.0	111.0	(7.0)

Equity Analysis Model

Global Spirits plc

Share Price Data

		Historical Data					
Accounts date	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Currency / units	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**
	12	**12**	**12**	**12**	**12**	**12**	**6**
Number of Shares & Eps							
Adjusted Earnings per Share (pence or equivalent)	67.2	55.40	59.00	64.60	65.50	76.20	38.20
Interim Dividend Per Share	11.95	12.55	13.20	13.90	14.60	15.50	16.60
Final Dividend Per Share	19.15	20.15	21.15	22.20	23.50	24.90	
Total Dividends Per Share (pence or equivalent)	31.1	32.70	34.35	36.10	38.10	40.40	16.60
Average number of common shares	2841	2,688.0	2,566.0	2,485.0	2,486.0	2,493.0	2,493.0
Average number of preference shares							
Share Prices							
Common Share Price - Low (pounds or equivalent)	7.74	8.85	9.10	7.27	8.57	10.30	10.82
Common Share Price - High (pounds or equivalent)	9.345	10.98	11.29	10.68	11.76	13.08	14.38
Common Share Price - Average	**8.5425**	9.91	10.19	8.98	10.17	11.69	12.60
Preference Share Price - Low (pounds or equivalent)							
Preference Share Price - High (pounds or equivalent)							
Preference Share Price - Average							
Risk rating							
Variability %		15	12	15	15	15	16
Beta (actual or estimate)		0.45	0.71	0.61	0.61	0.64	0.64
Assumed Market Risk premium	4.50	**4.50**	**4.50**	**4.50**	**4.50**	**4.50**	**4.50**
Assumed 10-year Gilt Yield	**1.83**	**4.75**	**4.50**	**4.25**	**4.00**	**3.50**	**3.50**
LIBOR or equivalent	4.63	**5.32**	**5.89**	**2.71**	**0.61**	**0.76**	**0.76**
Market Capitalisation							
Market Capitalisation - Common Stock	24,269	26,645	26,154	22,303	25,270	29,143	31,412
Market Capitalisation - Preference Stock	-	-	-	-	-	-	-
Market Capitalisation - Total	24,269	26,645	26,154	22,303	25,270	29,143	31,412
Minorities	-	198	677	715	779	740	965
Net Debt	-	4,782	6,494	7,661	7,311	6,611	8,483
Enterprise value [EV]	**24,269**	**31,625**	**33,325**	**30,679**	**33,360**	**36,494**	**40,860**

Equity Analysis

Equity Ratios							
Eps Growth %		(17.6%)	6.5%	9.5%	1.4%	16.3%	(20.3%)
P/E Ratio	12.7	17.9	17.3	13.9	15.5	15.3	16.5
Market / Book Ratio of Equity		6.71	7.48	6.92	6.31	5.56	6.12
Dividend Cover	2.16	1.69	1.72	1.79	1.72	1.89	2.30
Dividend Yield %	3.6%	3.3%	3.4%	4.0%	3.7%	3.5%	3.3%
Total Return to Shareholders %		19.9%	6.3%	(8.4%)	17.5%	19.0%	18.4%
EV Valuation Multiples							
EV / Sales	3.34	4.23	4.12	3.29	3.41	3.67	3.55
EV / Book Capital Employed		3.53	3.12	2.65	2.76	2.90	2.80
EV / EBITA	10.4	13.7	13.4	12.4	12.0	12.5	10.4
EV / EBITDA	10.38	12.71	12.38	11.34	10.79	11.37	9.57
EV / Staff Costs							
EV / Sustainable Free Cash Flow		18.5	17.7	14.9	17.6	18.0	16.5
Yields and Implied Growth Rates							
Sust. Free Cash Flow / EV (WACC minus growth)		5.4%	5.6%	6.7%	5.7%	5.6%	6.1%
Real WACC		3.0%	7.0%	4.2%	1.6%	1.3%	2.1%
Implied Sustainable Growth Rate		(2.4%)	1.4%	(2.5%)	(4.1%)	(4.3%)	(4.0%)

Equity Analysis Model

Global Spirits plc

Cash Flow Analysis

		Historical Data					Interim	
	Accounts date	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**Period**
	Currency / units	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**Total**
Cash Flow Summary		**audited**	**audited**	**audited**	**audited**	**audited**	**audited**	**2007-2012**
	Number of months	**12**	**12**	**12**	**12**	**12**	**6**	
CASH FLOW FROM OPERATIONS								
	Operating Profit	2,159	2,226	2,418	2,574	2,595	1,842	13,814
	Other Non-cash & Exceptional Items	62	113	37	(137)	(25)	(17)	33
	Investment Income			179	111	138	4	432
"Cash Profit"		**2,221**	**2,339**	**2,634**	**2,548**	**2,708**	**1,829**	**14,279**
	(Increase) / Decrease in Net Working Assets	(180)	(282)	(253)	334	(112)	(735)	(1,228)
	Tangible Asset Depreciation	181	198	223	302	283	168	1,355
	Net Capital Expenditure	(205)	(262)	(341)	(231)	(372)	(190)	(1,601)
	(Tax Paid	(368)	(369)	(522)	(474)	(365)	(214)	(2,312)
	(Dividends Paid)	(899)	(913)	(968)	(1,021)	(1,085)	(693)	(5,579)
Free Cash Flow before Interest		**750**	**711**	**773**	**1,458**	**1,057**	**165**	**4,914**
	(Net Interest Paid)	(237)	(320)	(415)	(305)	(311)	(229)	(1,817)
Internal Cash Flow		**513**	**391**	**358**	**1,153**	**746**	**(64)**	**3,097**
ACQUISITION & FINANCING CASH FLOWS								
	(Acquisitions),Disposals,(Investments)	(72)	(567)	(125)	(248)	(82)	(1,484)	(2,578)
	Increase / (Decrease) in Share Capital	(1,429)	(1,085)	(392)	85	(8)	(198)	(3,027)
	Increase / (Decrease) in Debt	988	1,090	359	(451)	(525)	1,283	2,744
	(Increase) / Decrease in Cash		171	(200)	(539)	(131)	463	(236)
Net Financing Cash Flow		**(513)**	**(391)**	**(358)**	**(1,153)**	**(746)**	**64**	**(3,097)**
	Balance check	-	-	-	-	-	-	-

Equity Analysis Model

Global Spirits plc	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Sustainable Cash Profit	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**	**£mill**
Operating Profit & Investment Income after Tax	1,774	1,829	2,134	2,207	2,246	1,517
Amortisation & Other Non-cash Adjustments	62	113	37	(137)	(25)	(17)
Depreciation	181	198	223	302	283	168
Replacement Capital Expenditure	(214)	(236)	(263)	(357)	(353)	(294)
Replacement Net Working Assets	(90)	(25)	(70)	(124)	(124)	(137)
Sustainable Entity Cash Flow after Tax	**1,713**	**1,880**	**2,061**	**1,891**	**2,027**	**1,237**

Workings

Accumulated Depreciation	1,007	1,149	1,390	1,733	1,974	2,142
Annual Tangible Asset Depreciation	181	198	223	302	283	168
Estimated Average Age of Fixed Assets (Years)	5.6	5.8	6.2	5.7	7.0	13
Compound Inflation over Half Life of Assets %	1.18	1.19	1.18	1.18	1.25	1.75
Net Working Assets	2,315	2,624	3,008	2,713	2,689	3,564
Annual Inflation Rate %	4.05%	0.95%	2.40%	4.77%	4.82%	4.00%

Equity Analysis Model

Global Spirits plc

Financial Profile	Historical Data					Interim
Accounts date	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Number of months	***12***	***12***	***12***	***12***	***12***	***6***
Annual % Growth Rates						
Sales Growth	3.0%	8.1%	15.1%	5.0%	1.6%	15.9%
Margins and Cost Structure						
Gross Profit % Sales	59.9%	59.9%	58.2%	58.1%	59.6%	62.0%
Marketing Costs % Sales	(15.5%)	(15.3%)	(14.3%)	(14.5%)	(15.5%)	(15.6%)
Other Overheads, Cost & Revenues % Sales	(16.0%)	(16.2%)	(18.2%)	(15.6%)	(16.2%)	(14.0%)
Total Exceptional Items & Goodwill Amort.% Sales (+/-)	0.5%	(0.7%)	0.3%	(1.8%)	(2.0%)	1.4%
Non-Interest Financial Income & Expenditure (+/-)	2.5%	2.5%	0.9%	0.6%	1.5%	1.7%
EBIT % Sales	31.4%	30.1%	26.9%	26.7%	27.5%	35.5%
Depreciation % Sales (for information)	2.4%	2.4%	2.4%	3.1%	2.8%	2.9%
Profitability / Return on Capital Employed						
EBITA % Capital Employed (pre-exceptionals)	25.8%	23.4%	21.4%	23.1%	23.2%	27.0%
Pre-tax Target Rate of Return 0n Book Value	30.3%	30.2%	21.2%	21.2%	21.4%	20.6%
EBITA % Market Enterprise Value	7.3%	7.5%	8.1%	8.4%	8.0%	9.6%
Pre-tax Target Rate of Return on Market Value	8.6%	9.7%	8.0%	7.7%	7.4%	7.4%
Asset Utilisation / Capital Intensity						
Sales / Total Assets	0.54	0.50	0.51	0.50	0.50	0.51
Stocks % Sales	33.0%	33.9%	34.0%	33.5%	35.0%	32.6%
Debtors % Sales	23.7%	25.5%	22.0%	21.7%	21.1%	26.6%
Creditors & Advance Payments % Sales	25.7%	26.9%	23.7%	27.5%	29.0%	28.2%
Net Working Assets % Sales	30.9%	32.4%	32.3%	27.7%	27.1%	31.0%
Tangible Fixed Assets % Sales	26%	26%	24%	25%	26%	24%
Depreciable Assets % Sales	16%	17%	16%	17%	18%	18%
Net Capex % Annual Depreciation	113%	132%	153%	76%	131%	113%
Average Age of Depreciable Assets (years)	5.6	5.8	6.2	5.7	7.0	12.8
Tax Ratios						
Effective Interest Rate [P&L] %	6.4%	7.7%	9.7%	9.7%	7.6%	6.0%
Effective Tax Rate [P&L] %	32.4%	24.9%	14.4%	21.3%	14.5%	45.2%
Cash Tax Rate [Cash Flow] %	17.6%	17.6%	26.2%	21.2%	15.5%	11.5%

Capital Structure & Credit Status						
Balance Sheet Gearing & Leverage						
Leverage: (Net Debt % Capital Employed)	53%	61%	66%	60%	52%	58%
Net Debt % Enterprise Value	15%	19%	25%	22%	18%	21%
Interest Cover Ratios						
Interest Cover: (EBITA / Net Interest Paid)	9.2	7.3	4.8	7.4	7.9	10.7
Interest Cover: (EBITDA / Net Interest Paid)	9.9	7.9	5.2	8.2	8.7	11.6
Cash Flow before Interest / Cash Net Interest	3.2	2.2	1.9	4.8	3.4	0.7
Income Leverage (Debt Repayment Ability)						
Gross Debt / Cash Retained Profit (years to repay)	12.5	10.3	12.1	9.6	7.3	9.1
Net Debt / EBITDA	1.9	2.4	2.8	2.4	2.1	2.0

Estimated Credit Rating						
Key Variables						
Return on Capital %	23.5%	21.1%	20.6%	20.0%	19.5%	25.0%
Total Debt % Capitalisation	58%	63%	69%	65%	58%	61%
EBIT Interest Coverage	9.2	7.3	4.8	7.4	7.9	10.7
Free Operating Cash Flow % Total Debt	25%	18%	15%	25%	22%	13%
Estimated Credit Rating	**AA**	**AA/A**	**AA/A**	**AA**	**AA/A**	**AA/A**
Indicative Credit Spread %	**1.50%**	**1.70%**	**1.70%**	**1.50%**	**1.70%**	**1.70%**

ADVANCED DIPLOMA

CASE STUDY EXAMINATION NOTE FORM ANSWERS

OCTOBER 2012

QUESTION 1 Business risk assessment

(10 marks, 18 mins)

Marking scheme – I have 20 points so 0.5 mark for each good point

Analysis and assessment of business risk.
Quantification on a scale of 1 to 10.

Starting with the quantification and cheating somewhat
Volatility (total risk) for company averages 15% [1]
On the observed volatility scale for equities of 12% (score 1) to 70% (score 10) this indicates about 0.4 [2]
Ungeared beta is technically a less good measure (only non-diversifiable risk) but on a scale of, say, 0.34 to 1.22 for ungeared beta, Global Spirits' calculated ungeared beta of 0.52 [3] would score about 3 [4]
Conclusion low to very low risk. [5]

Risk factors

- Spirits, wine and beer – in much of the world a basic consumable, [6] not particularly cyclical
- At best (or worst) on [7] addictive product range, dangerous to health
- Associated risk of increasing [8] litigation, constraints on marketing etc
- Potential margins so big as to allow company (and tax authorities) to adjust [9] price to consumer, to compensate for any potential fall in demand (adjust prices up or down).
- Globally strong [10] brands, many being number one market leaders
- Strategy is diversify [11] globally especially from developed towards developing markets with lower margins but higher rates of growth [12] – diversification facilitates smoothing of sales and profits
- Strategy to "premiumise" [13] – moving up market and developing/cultivating tastes in that direction
- In a strong position [14] politically around the world – as one of the biggest collectors of sales taxes for governments

- All evidenced in very strong cash [15] flows and very [16] stable financials
- Main risks are probably those associated with the [17] acquisition strategy, acquisitions always being risky, especially big ones, and the strategy of growth via expansion in developing countries e.g. [18] China, Turkey, Brazil
- Additionally there is always the risk of government regulation, [19] taxation, expropriation etc particularly but not exclusively in the developing world
- Overall conclusion; low risk – about 3 [20] on the 1-10 scale.

QUESTION 2 Calculation of IRR return to shareholders, with comment on how good the return and on factors for sustainability

(Total 14 marks, 23.4 mins)

2a) Annual average return on shares (9 marks, 16.2 mins)

Marking scheme – I have 26 points in a very detailed answer so, in principle, 0.5 mark for each key assumption or correct calculation, with a premium for close to correct IRR% figure

Quick and Dirty Check (not required)

Quick calculation from information in the question and from the case study financial analysis exhibits.

Capital gain = (12.73 x 2493) – (9.14 x 2841)
= 31,735.9 – 25,966.7 = 5,769.2

Annualised return = (6√31,736 / 25,967) – 1 x 100 = 3.40%

Average dividend yield over 5 years = 3.58%
Net decrease/(increase) in share capital =2,829 ie share buy-backs predominantly
Pro-rating compared with dividends = 2,829 / 4,886 x 3.58% = 2.07%

Total average annual return = 9.05%

Arithmetic average annual total shareholder return from case study is c. 11%

Suggests annual discount rate about 10%

IRR Calculation

I have assumed that dividends are paid 6 months [1] in arrears, but treating interim and final dividends separately. [2] A round semi-annual discount rate [3] has been used then grossed up by squaring to get annual rate.

Assume average number of shares, as given in Case Exhibits for each year, applies to both interim and final dividends [4] declared for that year, but lagged 6 months for dividend payment purposes.

Final dividend for 2005 [5] assumed to be 18.20 by backgrounds extrapolation from 2007, 2006.

Final dividend for 2011 assumed to be received [6] 6 months after shares sold.

Quarterly analysis would more accurately reflect dividend payments but would double the calculation work and would involve a quarterly discount rate. Ok if this method used. [7] If annual dividends used – not so good conceptually but not unduly penalised in marking.

Assumes share buy-backs occur [8] at year end, as an approximation – figures taken from cash flow summary and assumed to be zero [9] in 2006 – no information.

Assume "at the start of 2006" means at the start of financial year [10] 2005-2006 ie at the end of 2005.

From equity analysis page in the case study the arithmetic average return to shareholders is about 12% (NB this is not a correct or precise way of calculating equity return) so try 10% discount rate. [11]

GLOBAL SPIRITS RETURNS TO SHAREHOLDERS

	period	0	1	2	3	4	5	6	7	8	9	10	11	12	13	
[12] annual discount rate	10.25%	June	Dec	June	Dec	June	Dec	June	Dec	June	Dec	June	Dec	June	Dec	
semi-annual discount rate	5.00%	2005	2006		2007		2008		2009		2010		2011			
interim divi per share (pence)			11.95		12.55		13.2		13.9		14.6		15.5		16.6	[13]
final divi per share (pence)		18.20		19.15		20.15		21.15		22.2		23.5		24.9		[14]
number of shares (millions)		2841	2841	2841	2688	2688	2566	2566	2485	2485	2486	2486	2493	2493	2493	[15]
entry & exit share prices (pence)		914													1,273	[16]
cash flows (millions)																
purchase & sale of shares		(25,967)												31,736		[17,18]
share buy-backs / issues				0		1,429		1,085		392		(85)		8		[19]
interim dividends paid				339		337		339		345		363		386		[20]
final dividends paid			517		544		542		543		552		584		621	[21]
total cash flow		(25,967)	517	339	544	1,766	542	1,424	543	737	552	278	584	32,130	621	[22]
discount factors		1.0000	0.952	0.907	0.864	0.823	0.784	0.746	0.711	0.677	0.645	0.614	0.585	0.557	0.530	[23]
discounted cash flows		(25,967)	492	308	470	1,453	424	1,062	386	499	356	171	342	17,891	329	[24]
NPV at 10.25%	(1,783)	[25]														

NPV is negative 1,783 at 5.0% (10.25%). At 4% (8.16%) NPV is positive 756 (candidates not expected to do two IRR calculations, but some may do for extra marks) so estimated IRR approximately 9% annualised. [26]

For Information – IRR Calculation

GLOBAL SPIRITS RETURNS TO SHAREHOLDERS															
	period	0	1	2	3	4	5	6	7	8	9	10	11	12	13
annual discount rate	8.16%	June	Dec	June	Dec	June	Dec	June	Dec	June	Dec	June	Dec	June	Dec
semi-annual discount rate	4.00%	2005	2006		2007		2008		2009		2010		2011		
interim divi per share (pence)			11.95		12.55		13.2		13.9		14.6		15.5		16.6
final divi per share (pence)		18.20		19.15		20.15		21.15		22.2		23.5		24.9	
number of shares (millions)		2841	2841	2841	2688	2688	2566	2566	2485	2485	2486	2486	2493	2493	2493
entry & exit share prices (pence)		914													1,273
cash flows (millions)															
purchase & sale of shares		(25,967)												31,736	
share buy-backs / issues				0		1,429		1,085		392		(85)		8	
interim dividends paid				339		337		339		345		363		386	
final dividends paid			517		544		542		543		552		584		621
total cash flow		(25,967)	517	339	544	1,766	542	1,424	543	737	552	278	584	32,130	621
discount factors		1.0000	0.962	0.925	0.889	0.855	0.822	0.790	0.760	0.731	0.703	0.676	0.650	0.625	0.601
discounted cash flows		(25,967)	497	314	484	1,510	445	1,125	412	539	388	188	379	20,068	373
NPV at 10.25%	756														
IRR (semi-annual)	4.2855%														
IRR (annual)	**8.75%**														

2b) **(2 marks, 3.6 mins)**

(Marking scheme – get logic and calculations correct and answer in right range for 2 marks)

Assess actual return by comparing with CAPM required return on equity – familiar formula. NB marks lost if comparison is with WACC.

Use 5-year average beta = 0.604 (or beta when shares bought 0.45)
Use 5-year average gilt yield = 4.2% (range 3.5 to 4.75)
Use market risk premium of 4.5 (range 4.0 to 5.0)
Re = e.g. 4.2 + (0.604 x 4.5) = 6.9% (± 1%)

NB Question 4 gives a range of 6.4% to 7.8% for group Re.

So 9% return is very good, especially given the economic environment and general performance of equities over the period.

2c) **(3 marks, 5.4 mins)**

(Marking scheme: I have 14 points so ⅓ mark for each good point)

An overall summary of the most important points is required here, with the emphasis on the positive points rather than all the risks already covered.

Stable [1] financial ratios confirm non-financial analysis [2] of a relatively low-risk business, showing steady [3] growth and delivering fairly consistent margins and good return on capital employed [4] (23.4% ROCE versus target of 24.9, 5-year averages). Similar picture with return on EV versus target – on both of these comparisons the trend is improving steadily.
Gearing is stable and interest cover very comfortable [5] at 7.9 times.

Cash flow has been very strong [6] with 12.5 bn 'cash profit' generated, paying for all outgoings including the dividends and share buy-backs. Over the 5 years only 1.4 bn of [7] extra debt has been raised, to pay for the net acquisition cost of a similar amount.

Finally stable, and reasonably high, P/E [8] and EV/EBITDA multiples, averaging 16.0 and 11.7 respectively, indicate market confidence in the company's performance. A fall in multiples, if the market thought growth could not be maintained in the medium term, could threaten shareholder returns even if the company delivered the profits in the short term. [9]

Major threats to company [10] performance are; i) health and litigation issues re. alcohol sale and promotion [11] ii) failure of management to deliver strategy successfully.

Major strengths are; [12] i) market leading brands ii) [13] global diversification iii) revised global strategy. [14]

QUESTION 3: Major treasury/finance issues, prioritised

(Total 13 marks, 23.4 mins)

3a) 5 Major Issues **(5 marks, 9 mins)**

Marking scheme: evaluate <u>5 issues listed</u> for <u>overall credibility</u> (eg general conformity with the list below); evaluate <u>quality of supporting narrative</u>; then evaluate both in combination, giving careful consideration to areas <u>not</u> listed below. Evaluation bands: fail, marginal pass, clear pass, distinction.

Responses were expected to be drawn from the seven areas listed below. The actual responses identified 20 specific areas and almost all of these could be grouped under six of the seven listed – there was no mention of pensions:

(i) ensuring adequate funding to support growth strategy, given focus on emerging markets and "route to market" via acquisitions

(ii) currency translation exposure, eg policies for hedging net investment in number and range of acquisitions

(iii) hedging of currency exposures during the acquisition process [cross reference General Exam Q4 Lark-Alouette]

(iv) where centralisation of treasury control is not feasible, managing the level of local discretion over time i.e. "dynamic balance" in Treasury Organisation Profile terms

(v) commodity price risk, ie raw materials, packaging, fuel and transport
(vi) counterparty risk, both financial and trade

(vii) pension fund liabilities.

[- also the whole supply chain issue again, see Micasa Case (04.2012), but with 105 in-house production facilities]

This Question Part is a case Exam evergreen, usually necessary or at least helpful for stimulating thinking about questions likely to appear on the rest of the paper. Not surprisingly, responses were very good, with 16/19 passes averaging 60%.

3b) Prioritised Issues (8 marks, 14.4 mins)

Marking scheme: each student's comment on each issue (5 per student) was evaluated on the bands listed in 3.a. and averaged.

As already mentioned, student responses about major issues generally conformed to the listing in 3.a. but with more granularity, eg refinance ~ v ~ funding in general and some additional issues, eg capital structure, liquidity, cash management, eurozone stress.

In terms of number of student mentions, the priority ordering was:

- fx volatility
- refinance
- emerging market investment risk
- counterparty risk
- treasury management

In terms of specific issue prioritisation the ordering was:

- refinance and funding, ie approx £8.5bn spread fairly evenly over 2012-2016
- counterparty risk, eg cash balances, derivatives
- fx volatility, ie in general, Eurozone, LDCs
- cash + liquidity management, ie large numbers involved
- treasury management development and "dynamic balance", ie step change shift to LDCs.

Generally responses were good, although six of the weaker students did not quality all of the issues previously listed and pass rate fell to 11/19.

QUESTION 4: In-house calculation and use of WACCs.

(Total 12 marks, 21.6 mins)

4a) (4 marks, 7.2 mins)

Marking scheme; I have 18 points but there are more – so give ⅓ mark for each good point, given only 7.2 minutes

- Risk-free rate – short, medium or longer term view? [1]
  - to match timescale of acquisitions/investments use medium or long term preferable (10 to 20 year gilts) [2]

  Which Government instrument used? [16]

- Equity risk premium – over the last 25 years of the ACT exams figures as wide as 0% [3] and 10% have been argued! Calculations change all the time with volatility in equity markets [4] and interest rates. As above a longer-term [5] average seems most appropriate but arguably not back to 1900! Most popular currently-used figures are between 4 [6] and 5% for UK, USA, Europe.
  Also issues of arithmetic versus [7] geometric averages.

- Levered beta again depends very much on time period, [8] frequency of observations and detailed methodology e.g. which proxy id used for "the market". LBS data, quoted in ACT materials, are based on the last 5 years, monthly data – more stable. [9] American analysts tend to use a "moderated beta".

- Unlevered formula [10] generally agreed (a totally theoretical model) but eg Damodaran treats cash and debt separately. Debt beta assumed to be zero.

- Tax relief rate should be the actual weighted average [11] tax rate achieved on actual borrowings – not the P&L effective tax rate, [12] which is usually lower because of tax-efficient financing, but which is often used.

- Pre-tax cost of debt (weighted average cost of debt) [13] – publicly available evidence is changing all the time [14] – hard to estimate with confidence, ok if company gives full details. Some analysts use a generic cost based on credit rating. [15]

- Debt and equity weightings should be based on market values, [17] but book values are often (wrongly) used. Latest figures, historic average or [18] target D/E ratio?

4b) (3 marks, 5.4 mins)

(Marking scheme; I have 15 detailed points but there are more – give ⅓ mark for each good point, given only 5.4 minutes)

All the issues relevant [1] to 4.a. can also affect the group's Spanish WACC calculation as well as the systemic reasons for differences.

- The required equity return of 11.5% (compared with 6.4 to 7.8%) reflects the higher level of equity risk [2] for Spain versus the US/Europe [3] /World diversification of group shares.

- Based on the higher risk-free [4] rate for Spain, applied to the equity calculation, and a higher risk premium, [5] at 7.53% although the 5-year average figure is only a little higher than the 4.5% to 4.0% of the group analysts.

- Company uses Spanish [6] comparables for unlevered beta, to pick up any inherent [7] business risk differences from the rest of the group (looks a little high at 0.70 versus 0.54 to 0.66).

- Levered beta differences will reflect different assumptions about the tax rate [8] but also [9] capital structure. Spanish levered to unlevered ratio of 1.2 versus group 1.16 ratio might suggest that the company uses the target's [10] gearing and that it is higher for the Spanish entity (about 22% leverage versus about 19%). But the later note says GS corporate ratio is used for the D/E ratio. [11]

- The tax rate for the Spanish WACC reflects US funding deductible at the US rate, [12] whereas the group funding would be more of a mix.

- The "Spanish" cost of debt reveals the group's methodology – US RFR, GS credit spread, US-Spain 5-yr [13] swap rate – for actual US-based cost of funding that particular subsidiary.

- Summary - Spain WACC [14] is higher because of the higher equity risk and despite lower cost of debt.

4c) Ethiopia JV **(5 marks, 9 mins)**

Marking scheme; I have 13 detailed points but there are more – give 0.4 mark for each good point, given only 5.4 minutes

- 10-year risk-free rate not readily [1] available and/or volatile. Maybe look for similar neighbours with reliable RFR, [2] or for relevant continent.

- Risk premium – same as above [3] [4] e.g. no reliable stock market analysis, so look elsewhere on same continent

- Unlevered and levered betas – there may be no comparable [5] quoted companies with measurable betas or reliable stock market analysis. Try neighbouring countries or use group [6] unlevered beta and [7] re-lever for group's capital structure.

- Cost of offshore funding – no problem – same method as for Spain [8] i.e. US-based calculation..

- Swaps rate reflects interest rate differential but inflation differential [9] might be bigger so need to take a view. Swap rate might not be available.

- Onshore funding – use actual or estimated cost of local debt to the borrowing entity, which may be difficult [10] to establish in advance.

- D/E – use group ratio unless entity off balance sheet and highly leveraged, then use that entity's gearing ratio [11] if WACC required.

- Tax rate should reflect actual tax shelter achieved by actual funding mix/borrowing vehicle. Tax rates and regulations may not be known or stable for [12] local funding, but OK for US funding. [13]

QUESTION 5: Structure of the company's debt profile.

(10 marks, 18 mins)

Marking scheme; I have 38 very detailed points so ⅓ mark for each good point, because can't be expected to get them all

The £7,995million of debt is dominated by bonds and debentures [1] (92.7%), with bank loans, overdrafts and credit support obligations are only 3.1% [2] and predominantly due within one year. [3] GC has lots of small bond issues. Together with any unutilised facilities of £2,174mill these are for purposes of cash and [4] working capital management plus unforeseen events plus banking requirements [5] in the many countries around the world. In addition, at B/S 2011 GC held £1,584million in cash, [6] equivalent to 19.8% of total borrowing. **Principle is to minimise bank finance in favour of [7] capital market finance and keep plenty of cash for contingencies. Company has in fact become less diversified [8] in terms of sourcing its debt over recent years – is this wise / short-sighted? Big risk if rating threatened [9] – cost and availability of debt, especially beyond year 5 [10] depending on expansion plans.**

Since 2007 bond finance is up by 19.7% of the total, with CP and MTNs down by 20% of the total and bank finance down 2.1% of the total. USD [11] issues represent 64.2% of total debt, Euro issues [12] 32.8%, with 3.2% various other. Bonds represent cheap, covenant light finance, with longer maturities - in the volumes [13] that GS requires and can command, provided its credit rating is carefully managed. GS is effectively seen in the USA as an American company [14] (dual quote for shares and 50% US shareholders). It has an established capital [15] market track record on Wall Street. **Principle is to borrow where strongest and in deepest markets. [16] Risk is extreme dependence [17] on Wall Street and possibility of seriously bad publicity re. alcohol.**

17.8% [18] of debt raised is swapped out of UDS and 7.8% is swapped out of Euros, mainly into GBP [19] (22.3%). From question 4 we get an indication that GC may actually finish up with cheaper [20] debt by issuing in USD and Euros then swapping into GBP and other required currencies. Required currencies are predominantly USD (46%), Euro (25%) and GBP (22%) but other currencies [21] are increasing with acquisitions. **Principle is to swap [22] cheaply into currencies as required by operations. Risk is that swap rates and markets**

may not remain so favourable especially re. developing countries. [23]

Debt maturing within one year is equal to 15.5% [24] of the total, plus 2.7% of on demand facilities. £1,874mill (23.6%) is due in 2013 and [25] £1,401mill (17.7%) in 2014, followed by annual amounts less than 10% [26] of the total (£800mill) out to year 6, with even smaller amounts repayable beyond that out to 2036. In comparison annual free cash flow has averaged £632mill over the last five years and £950mill the last two. [27] The exceptional re-financing spike in 2013/2014 is a result of the emergency measures taken in 2008/2009, during the banking and economic crisis, when an extra £2,808mill [28] was raised. **Principle must be to re-finance the "spike" with an "exceptional" bond issue [29] any time now when the climate is reasonably favourable, rather than leave it to 2013. Aside from the 2013/2013 £3,275 million spike, principle seems to be to keep annual maturities below 10% of total debt out to year 6, then declining, which is easily covered [30] by free cash flow. N.B. policy limits maturities to 50% of net debt which, at £3,205m, is hardly limiting. Based on issuing largely a mix of 5-year and 10-year money with the balance in favour of 5-years, [31] and with some, presumably "opportunistic debt ",[32] out to 25 years. Big risk is the ability to re-finance the [33] spike: other maturities look manageable.**

The average all-in interest cost is 4.9%, (4.8% and 6.2% in previous years). MLT debt cost has risen slightly from 5.6% to 5.8% (impact of the emergency funding?), [34] while ST debt cost has fallen from 6.4% [35] to 4.9%, not surprisingly. Also not surprising, given current low interest rates, the proportion fixed has increased from 42% to 58%, [36] with corresponding reductions in floating rates. **Principle seems to be to manage cost of funding as stable [37] and as low as possible, via source of funding and judicious fixing - exploiting GS's strong, global market position, its value-driven operating strategy, strong cash flows and reasonably conservative capital structure**. Risk is that rates can only go up from here [38] and fixes don't last for ever.

QUESTION 6: Relationship and non-relationship banks.
(Total 9 marks, 16.2 mins)

6a) (5 marks, 9 mins)

Marking scheme; I have 28 or so detailed points so this question could have carried double the marks, so half the points would be good in the time allowed – so ⅓ mark for each good point. But important to make links between particular banks' offerings and CS's requirements

To a certain extent all these big banks offer the wide range of banking services with global representation [1] - as required by a global business like that of GS. However, classifying them according to their relative regional strengths we might summarise them as follows;

5 with strengths in USA / Americas [2]
6 with strengths in Europe
4 with strengths in the Asia / Africa [3] / Japan [4] (double counting Santander here)

As to relative strengths across banking activities we might summarise them as follows:

2 primarily for commercial banking [5] regionally - Santander and Standard Chartered

2 with the leading corporate [6] cash management systems (as well as capital market and commercial banking expertise) – CITI and HSBC
10 with capital market [7] and commercial banking expertise – the rest

The regional concentrations globally very much reflect the three-way split of GS's business [8] – North America / Europe / developing world.
The predominance of banks (12) with capital markets expertise and placing power, based in USA [9] and Europe, reflects GS's reliance on USD and EURO bond and other capital markets products. [10]

The 10 "universal" banks have the massive balance sheets that are needed for extensive [11] derivative transactions, also heavily utilised by GS for both interest rate and currency swaps. The currency swaps primarily involve USD, EURO and GBP- all well covered by regionally-based [12] banks.

These 10 can also provide advice and support services relevant to GS's acquisition [13] activities around the world – not only the M&A expertise but local knowledge about prospective acquisitions [14] and local market conditions.

There is also GS's requirement for informed equity [15] analysis as well as equity capital market services [16] to support its share issue and share buy-back activities. It is important that the company's strategy, latest initiatives and results are well understood [17] and promoted favourably in the equity markets to ensure that all the company's efforts are faithfully reflected in the share price. Most of the 14 banks have their respective equity activities.

As to commercial banking products, [18] such as current accounts, overdrafts, loans, guarantees etc – the relationship banks provide pretty comprehensive [19] global coverage of GS's main markets, if not all the developing countries that they are now moving into. It does not currently have a big requirement for bank loan finance but it does require enough AA-rated banks for its considerable Money Market deposits.

The total number of relationship banks may look to be on the [20] high side, as does the predominance of banks with strong capital market expertise, particularly the American banks. [21] But GS has large volumes of various kinds of investment banking business and will want enough relationship banks to; ensure [22] competitive pricing, spread the work [23] around and diversify [24] its banking counter-parties to reduce its exposure to any single bank. Banks have proved to be much more vulnerable since 2007 and also increasingly face [25] constraints on the range and scale of their activities, as well as their own exposure to particular client names. On the other hand the number of relationship banks needs to be small enough that there is enough [26] profitable business from the company for all

of them – the essence of mutually beneficial relationship banking.

6b) (4 marks, 7.2 mins)

Marking scheme; I have 23 or so detailed points so this question could have carried double the marks, so half the points would be good in the time allowed – so ⅓ mark for each good point.

Acquisitions [1] (several per year) mean proliferation of banks and banking [2] facilities with resulting duplication, complexity, [3] redundancy – the acquisition inheritance. More generally GS's strategic expansion globally (180 markets and 105 production plants) [4] means they will have some small-scale [5] activities all around the world, including many developing countries not well covered or not covered at all by their relationship banks. [6] Commercial banking facilities [7] will be required in all of the company's operating locations for purchasing, payments, payroll, working capital facilities, cash handling, money transmission, [8] FX etc.

Local banks may also offer particular, valuable local [9] expertise e.g. on tax, trading regulations, local culture, political contacts, [10] local markets, competitors or particular product variants [11] tailored to unique aspects of local conditions. It may also be expedient or required in some countries for expatriate [12] banks to use local banks. Local banks may be convenient and competitive for small-scale local financing e.g. [13] overdrafts, leasing, asset finance, trade finance. Some overseas joint [14] ventures may need to raise more substantial debt funding from or via local banks.

So in rationalising [15] banking arrangements after acquisitions and given the need always to seek savings [16] and economies there is a constant need to keep reviewing [17] and reducing the number of non-relationship banks while maintaining [18] essential services and grass-roots business relationships.

There needs to be a continuing or periodic review, [19] from central treasury, of non-banking relationships, including the degree of exposure [20] to all the banks which may not be from the first rank of creditworthiness and the [21] volume of business being given to those banks. There also needs to be a framework [22] for local finance / treasury departments to use as a consistent guide to monitoring the banks' operating performance, [23] pricing and value for money.

QUESTION 7: Future Growth, LDCs and translation risk

(Total 16 marks, 28.8 mins)

More precisely, net investment in foreign operations . . .

7a) Increase in net investment exposure (4 marks, 7.2 mins)

Marking scheme: the answer to this Part required a definition of translation exposure (method) and a calculation. So responses were evaluated on "method", ie right, partly right, wrong and – given the method – on the subsequent "calculation", ie right, wrong. The Question was clearly about net investment exposure (b/s) but 6 students took a predominantly or wholly P/L perspective on translation risk . . . . the "method"/"calculation" scheme gave some credit for this]
Taking a b/s approach:

- Table in question projects 2011 b/s ahead for 5 years at historic level of CAGR = 7%, b/s grows by £8bn.

- Net investment exposure is equity plus debt, assuming debt is in non-domestic currency

- Equity and gross debt is historically around 70% of total liabilities, ie:

  2007 $\frac{9837}{13958}$ = 70%

  2011 $\frac{14180}{19777}$ = 72%

- So, if assumptions are realistic, LDC-type net investment exposure will increase by:

  75% of 0.70 (27738 – 19777)
  ie 75% of £5.572m

  = £4180m

- Or, projecting equity + gross debt to 2016 at 7% CAGR:

	2007	2007-11	2011	2012	2013	2014	2015	2016
	GBP m		GBP m	GBP m	GBP m	GBP m	GBP m	GBP m
	Actual		Actual					
B/S: Total Liabilities	13958	CAGR 9%	19777	21161	22643	24228	25924	27738
(Assume CAGR 7% from Base Yr)			Base Yr	Estimate				
[Equity + Gross Debt]	9837	CAGR 10 %	14180	15173	16235	17371	18587	19888
(Assume CAGR 7% from Base Yr)			Base Yr	Estimate				
[Margin]				993	1062	1136	1216	1301
				Estimate				
[Cumulative]				993	2055	3191	4407	5708
				Estimate				

- £5,708 x 0.75 = £4,281

The 13 candidates who took a B/S approach had a disturbingly wide range of definitions for net investment risk including: equity, debt, equity-debt, debt-equity, b/s-debt, b/s-equity-debt. Only 1 student achieved a pass mark.

7b) Guidelines for managing risk (9 marks, 16.2 mins)

Marking scheme: responses expected to cover a substantial number of the points listed below. Evaluation based on combination of number of points, credibility and quality of narrative. Evaluation bands: fail, marginal pass, clear pass, distinction.

- As a first step use structural hedging, ie borrowing in local currency.
- However, capacity/liquidity of local currency debt markets to lend large amounts and provide hedges may be limited.
- Local counterparties: are competitive trades possible? Is counterparty risk acceptable?
- Also the interest cost may be relatively high and out of line with the differential implied by the exchange rate.
- If borrowing local currency is not feasible it is unlikely that cross currency interest rate swaps will be available either.
- Indeed, if the local currency is in the long term expected to depreciate against GBP, then the periodic use of derivatives to hedge this just pushes the problem into the future.
- Need to monitor impact on parent net worth and gearing (b/s), and on interest cover and repayment (b/s, p/l)
- So a commercial approach might be more appropriate, ie adjust prices at or above inflation and hold costs at or below inflation.
- The above discusses net investment risk at the individual country level.

- Over a period of five years several countries/currencies are likely to be involved. This provides the opportunity to consider the risk at the portfolio level. Scale/number of diverse investments is important for the portfolio approach to work as in the long run some investments are likely to fail and the parent must be able to sustain the loss [cross-reference General Exam Q7, JV risks in high growth/high sovereign risk countries].

7c) Recent policy restatement (3 marks, 5.4 mins)

Marking scheme: As for 7b: number of points, credibility, quality of narrative.

- There is room for a wide range of views on the appropriateness of the policy. One view is expressed below. Another (not necessarily contradictory) view is that the policy provides latitude to fund in hard currency at current low rates and live with the exchange risk for the time being. So it was left to candidates to decide on and argue a point of view. Pass rate was 12/19.
- The restatement of policy hedging limits at 0 – 100% recognises the reality that in some instances it may be impossible and/or pointless to hedge using derivatives.
- However, as the pattern of LDC investment develops and a profile of exposures emerges one would expect to revisit the policy with a view to achieving greater precision.

QUESTION 8: Growth in LDCs, "dynamic balance" and local discretion in treasury operations

(Total 16 marks, 28.8 mins)

Marking scheme: It would be unfair to be overly prescriptive about the appropriate response to this Question, so here again a combination of number of points raised, credibility and quality of narrative was used to mark candidates within bands of clear fail, marginal pass, clear pass and distinction.

8a) Local discretion (6 marks, 10.8 mins)

- The areas considered most likely to require local discretion are bank relationships, creditor and debtor management and currency hedging.
- A presumption in favour of relationship/approved banks and group policies is assumed.
- However in the absence of relationship banks, then local custom, competitive positioning and sophistication of local financial markets, eg for derivatives, dictates resorting to the art of the possible.
- The difference between majority-owned subsidiaries and minority stake joint ventures is a major consideration. So it is important to build into the JV agreement at the outset rules for resolving likely areas of disagreement, eg dividend level, investment criteria, incremental investment, capital structure, risk management and conceivably exit.

- So prime areas for debate are:

  - bank relationships
  - debtor management
  - creditor management
  - currency hedging

- Others would include:

  - balance sheet
  - dividend
  - capex
  - interest risk
  - insurance

- These headline areas are listed on the left hand column of the table below and sub-divided to provide greater detail, eg for elements which might <u>not</u> be considered discretionary.

8b) (i) Local discretion: majority owned (5 marks, 9 mins)
(ii) Local discretion: owned 50:50 or less (5 marks, 9 mins)

- The middle and right hand columns of the table address Part 8b, (i) and (ii).

Most likely areas for providing discretion are marked "X"

8a Local discretion	8b (i) Majority subsidiary	8b (ii) JV 50% or less

(6 marks,10.8 mins)		(5 marks, 9 mins)	(5 marks, 9 mins)
• **Bank relations**			
- choice local bank	X	Approved bank or justify.	JV agreement, Group discretion to alter ((GDTA).
- settlement	X	Approved bank or justify. Agree exposure limits with Group.	Work to influence.
- local debt	X	Agree local policy with Group, eg documentation.	JV agreement, GDTA.
- local deposit	X	Agree local policy with Group, report on performance, counterparty exposures.	JV agreement, GDTA.
- cash liquidity management	X	Group network or justify. Agree policy, limits with Group.	Work to influence.
- trade finance	X	Approved bank/policy or via Group.	JV agreement, GDTA.
- fx hedging	X	Approved bank/policy or via Group.	JV agreement, GDTA.
• **Debtors**			
- terms of trade	X	Qualify for competition, custom.	Local discretion.
- quality counterparty	X	Agree with Group.	Work to influence.
• **Creditors**			
- terms of trade	X	Qualify for competition, custom.	Local discretion.
- quality counterparty	X	Agree with Group.	Work to influence.
• **Currency hedging**			
- transaction policy			
- contingent policy			
- execution	X	Approved bank policy or via Group.	Local discretion.

Less likely areas:

8a Local discretion (6 marks,10.8 mins)		8b (i) Majority subsidiary (5 marks, 9 mins)	8b (ii) JV 50% or less (5 marks, 9 mins)
• **Balance Sheet**			
- capital structure			
- net investment hedging	X	Group, no local discretion.	JV agreement, GDTA.
• **Dividend**			
- level	X	Group, no local discretion.	JV agreement, GDTA.
- fx hedging	X	Group or justify.	Local discretion, work to influence
• **Capex**			
- business criteria			
- financial criteria	X	Group or justify.	JV agreement, GDTA.
• **Interest Risk**			
- policy			
- execution	X	Approved bank policy or via Group.	Local discretion.
• **Insurance**			
- big ticket			
- small ticket	X	Local discretion	Local discretion.

- Whether through tedium, lack of inspiration or time, about one-third of candidates managed only a page or less of script which is unlikely to be adequate for a 16 mark Question. So the pass rate (8/19) was again low.

EXAMINERS REPORT OVERALL SUMMARY

OVERVIEW

	General Exam	Case Exam	Combined
Marks	46.9%	49.6%	50.3%
Questions	7	8	15
Students	20	19	39
Pass #	7	6	13
Pass	35%	32%	33%
Range of marks %	27.6% to 68.5%	34.6% to 63.6%	

This was a disappointing set of results overall. We understand, however, that there were quite a few candidates who have not been studying currently but who decided to take the exams and generally did not achieve good results. The distribution of marks reflects these two constituencies. Looking at the distribution of the marks on the two papers the whole distribution is about 5 marks lower than average; 34% achieved pass marks of 50 or above, 51% were in the 40s and 15% in the 30s.

There were, however, two very good candidates with marks consistently in the 60s.

I have detailed the results by question, which show that some questions had very low pass rates and very low average marks;

General exam	marks available	passes out of 20	average mark
Q1	16	5	36.9%
Q2	22	11	50.5%
Q3	12	9	42.7%
Q4	16	6	41.1%
Q5	8	10	48.2%
Q6	14	7	44.7%
Q7	12	20	67.4%

Case exam	marks available	passes out of 19	average mark
Q1	10	14	62.4%
Q2	14	12	50.1%
Q3	13	11	53.4%
Q4	12	2	33.2%
Q5	10	9	47.7%
Q6	9	17	69.0%
Q7	16	7	45.4%
Q8	16	8	45.5%

Corporate Finance and Funding Summary (both papers)

Overall the quality of answers on the eight corporate finance and funding questions across the two papers (105 marks out of 200) was not as good as in recent years. The average mark was 47.8% and there were 9 passes plus 2 marginal passes out of 20 candidates. Two candidates were at distinction level but 3 of the fails were bad fails, with marks in the 30s.

Treasury and Risk Management Summary (both papers)

There were seven questions on treasury and risk management across the two papers (95 marks out of 200). As for CF&F the results were significantly worse than in previous years. The average mark for the 20 candidates was 48.7% and there were 7 passes plus 7 marginal passes. At distinction level the two CF&F distinctions were joined by a third candidate. There were 4 bad fails but mainly not the same as those in CF&F.

EXAMINER'S REPORT Oct 2012 CASE STUDY EXAMINATION

Question 1 Business risk assessment (Avg 62.4%, Pass 14)

The question asked for a business risk score from 1 to10 base on an assessment of the positive and negative business risk factors. On the whole this was well answered (average 62%, 14 passes), with very good use of the information given in the case study background material. However, the answers were too much descriptive, too little analytical and with the emphasis too much on the negatives, too little on the positives. Some candidates didn't actually give a rating score as requested. Those that did scored the business more risky than I would, rightly or wrongly (4 to 7, as against my 3).

Question 2 Calculation of IRR return to shareholders, with comment on how good the return and on factors for sustainability. (Avg 50%, Pass12/19)

Part 2a (average mark 50%,12 passes) required correct DCF calculations and approximation of the IRR to shareholders, but it also required some careful thought about definitions and timing of cash flows in light of what happens in the real world. It allowed for differing assumptions about the timing of cash flows, which affected the complexity of the DCF calculations e.g. annual, bi-annual or quarterly dividend flows. Disappointingly, but perhaps understandably, most candidates assumed, without any discussion, a single annual dividend payment with a one-year time lag – I expected separate treatment of interim and final dividend each with a six-month time lag.

The question was worded to help candidates deal correctly with the changing number of shares, i.e. in aggregate rather than per share, but the point was lost on and ignored by most candidates. Quite a few candidates did no DCF at all, while others carried out a hybrid involving compound average growth rate in the share price – not very satisfactory and with poor results. Many candidates missed the significant share buy-backs.

Finally, purchasing the shares "at the beginning of 2006" means at the end of 2005 i.e. at financial year-end June 2005 – for some reason most candidates wrongly assumed June 2006 as time zero.

Part 2b (average mark 41%, 9 passes) asked for an assessment of how good the return had been – a case for quoting the CAPM required return on equity, if ever there was one, but missed by quite a few candidates. Four candidates wrongly used their favourite WACC to assess the return. Better candidates also referred to the difficult economic context of the last few years in assessing relative equity performance.

Part 2c asked what factors gave confidence regarding future delivery of shareholder value or threatened it. Unfortunately the answers were dominated by a repeat of the earlier risk analysis rather than the various positive financial and non-financial factors which support sustainability. The marks here however were good, very much in line with those achieved in 2a.

Question 3 Major treasury/finance issues, prioritised

(Avg 53.4%, Passes 11/19)

For 5 marks, Part 3a about identifying major treasury and finance issues is an evergreen and a natural follow- on to Q1 about business risks and Q2 about financial performance. Answers were very good, with average marks of 60% and 16 passes.

Part 3b for 8 marks required candidates to qualify and prioritise their 5 chosen major issues. The weaker students failed to qualify some of their chosen issues and the pass rate fell on this more difficult part of the question (average marks 49%, 11 passes).

Question 4 In-house calculation and use of WACCs.

(Avg 33.2%, Pass 2/19)

With an average mark of 33% and only 2 passes this is the worst-answered question I have marked in 25 years – and it was on the practicalities of WACC calculations. Answers revealed a lack of technical knowledge about the contributory factors, about the difficulties of estimating values for variables and very little imagination in the face of uncertainty.

Part 4a asked for likely reasons for different analysts arriving at different WACCs for the same company (detailed calculations were given). The worst answer was

that “they used different assumptions or different data”. Second worst answer was to nullify the question by declaring that the differences aren’t very big really so nothing to answer. Not much at all about choice of a risk-free rate instrument, the range of estimated for the market risk premium (arithmetic versus geometric averages, choice of time period), difficulties in estimating beta (low R2 statistics), tax rate etc.

Result – 3 passes out of 19, average mark 29%.

Part 4b asked for reasons why the company’s detailed WACC for a Spanish investment differed from the company WACC (average mark 42%, 4 passes – not much better). The poor answer simply said that Spain was riskier so higher WACC – true but why did we give the detailed WACC calculation, which revealed that the debt component of the calculation was based on US bond funding, not local debt, which most candidates missed?

Part 4c (31% 4 passes) asked for problems involved in calculating a WACC for an investment in an un-leveraged joint venture in Ethiopia, funded by a mix of local and off-shore debt – so plenty of guidance in the question. Again, the details given in the question were largely ignored and some candidates wrote about the general problems of managing a jv, which is a good question but it was not on this paper. Some informed speculation about the difficulties of establishing appropriate values for sophisticated market and company calculations in undeveloped markets and practical, structured ways of dealing with them would have been nice and was delivered by about four candidates. A quarter of the candidates did not have a clue, so what is the point of knowing the WACC formula if you can’t apply it intelligently in a practical
context?

<u>Question 5</u> **Structure of the company’s debt profile.**

(Avg 47.7%, Pass 9/19)

Across all candidates all the relevant issues were covered and well discussed and some candidates wrote very good answers to this rather open-ended question (top marks 70%, 73%, 73% and 80%), but the average was only 48%, with 9 passes. Most candidates picked up some issues but not all e.g. most picked up the reliance on US bonds, but many missed the associated FX swap activity, or the changing maturity profile.

Question 6 **Relationship and non-relationship banks.**

(Avg 69%, Pass 17/19)

This question was demanding and proved to have a lot more substance than I envisaged at first, so both parts could have carried twice the marks. In marking therefore I did not expect complete answers but some of the candidates' best, most practical answers were delivered here (average mark 69% 17 passes).

In Part 6a most candidates picked out the two big issues – the relative functional specialisms and the geographical strengths of the various relationship banks. Some candidates were better than others in relating this mapping back to the company's particular requirements identified in earlier questions. Some candidates didn't seem to know anything about the 14 named relationship banks, others did not appreciate the banking implications of a massive swapping operation, yet others did not pick up the corporate advisory requirement of an acquiring global group or the need for diversification of banking counter-party risk - and one candidate seemed to think that the only banking requirement was for loans, which is actually of minimal importance for GS.

In part 6b, there were even better answers, especially from candidates who had clearly seen a lot of the issues of non-relationship banking first hand. The answers were strongest on the problems of managing lots of small local banking relationships and also the difficulty of the financial/treasury control of overseas subsidiaries. They were generally less aware of the great variety of reasons for employing local banks in developing countries.

Question 7 **Future growth, LDCs and translation risk**

(Avg 45.4% passes 7/19)

This question deals with a key issue for Global Spirits, given their major shift in growth strategy from focus on developed low growth countries to less developed high growth (for their premium brands) countries. This question is a prime example of how business strategy drives the shape of the treasury function (as in Question 8).

The main focus of this question is net investment risk. For 4 marks, Part 7a asked candidates to estimate the future exposure. There was considerable confusion about what constituted net investment exposure, as discussed in the

Note Form Answers and only one candidate achieved a pass mark (average mark 35%)

For 9 marks Part 7b invited students to suggest guidelines for managing the risk. The big issues here are the capacity /competitiveness of local banks to provide domestic funding as a structural hedge and the availability/desirability of using cross currency interest rate swaps instead. Candidates fared better on this part (average marks 50%, 10 passes).

For 3 marks Part 7c asked candidates to comment on the appropriateness of the recently revised policy for managing net investment risk, as quoted in the Question. This gives discretion to treasury to hedge 0-100%. This was quite an open-ended question and elicited responses ranging from "recognising reality" to "excuse to fund in hard currency at current very low rates" (neither of these views necessarily right or wrong, depending on individual's rationale). A more subtle point made by some students was that only a portfolio approach is really feasible, combined with a policy of increasing product price to compensate for loss in value of currency. And the diversity required in a portfolio approach favours the biggest players.

<u>Question 8</u> Growth in LDCs, "dynamic balance" and local discretion in treasury operations (Avg mark 45.5%, passes 8/19)

This is a topical and also quite an open-ended question, and coming at the end of the Paper is a real test of stamina! Some appeared overcome, with six candidates submitting only a page or less to bid for 16 marks.

For 6 marks Part 8a asked candidates to identify the areas of treasury activity where they might expect to have to permit local discretion if centralised control of treasury should become unfeasible due to local circumstance. Bank relations featured in most responses as well as currency hedging - the latter regarding choice of bank counterparty rather than hedging policy. Thereafter responses became sketchy (avg mark 48%, 7 passes).

For a total of 10 marks Part 8b required students to differentiate between majority owned subsidiaries (i) and 50/50 or minority owned subsidiaries (ii) in terms of discretion permitted. Generally, those who struggled with the first part struggled more with the second (avg mark 44%, 8 passes).

Summary of Questions 1, 2 ,4 ,5 and 6, Case Exam (55 marks)

Overall 10/19 passes (plus 3 marginal passes), average mark 51.3%, range 32% to 68%. No candidate failed all five questions, 1 passed all five questions.

This was an encouraging result overall, when compared with the General Exam result, since this proved to be quite a demanding paper in terms of its theoretical and practical scope and the wide range of issues covered. Candidates performed quite badly on the most technical question (question 4 on WACCs), but did particularly well on the risk and bank relationship questions. Only the bottom third of candidates looked under-prepared, one seriously so.

Summary of Questions 3,7 and 8, Case Exam (45 marks)

Overall 7/19 passes (6 marginal passes), average mark 47.8%, range 29% to 71%. There was an overlap of 10 between the 13 passes/ marginals for Q 1,2,4,5,6 and the 13 passes/ marginals for Q 3,7,8.

The overall pass rate is disappointing but two of the three questions (7,8) were not “run of the mill”, although topical. Page one of this report flagged the possibility that a sizeable number of candidates not currently studying may have decided to take the exams and the evidence in the results would support that view…..it is the non-routine questions which can defeat those who have not been recently engaged in the study process.