TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

The Association of Corporate Treasurers

Examination Paper, Solutions and Examiner's report

Paper: MCT Case Study Exam

APRIL 2011

All questions relate to the PPP Group Case Study. The financial summary and analysis in the Appendices to the Case Study include figures for the three full years 2007 - 2009 plus the half year figures to June 2010. Note that the business is not particularly seasonal.

QUESTION 1

Required:

a) **Using whatever concepts and tools of analysis that you consider appropriate carry out an assessment of the company's strategic and operating environment, with the emphasis on assessing factors relevant to delivering shareholder value on a consistent basis. Shareholder value is the company's current priority following recent years' focus on the buy-out, listing, and subsequent strategic repositioning.**

(7 marks)

b) **Based on your analysis summarise how "benign" or "adverse" you think the company's operating environment is, all things considered.**

(2 marks)

(Total 9 marks)

QUESTION 2

You have the accounting statements plus a financial analysis based on the full years 2007 - 2009 and the first half of 2010.

Required:

Summarise:

a) **The company's track record, since its listing in 2007, in delivering bottom-line earnings from the assets employed.**

(5 marks)

b) **The key features of the company's cash flows for the period 2007 to mid-2010.**

(4 marks)

c) **Its current credit strength bearing in mind your answers to Questions 1a), 1b), 2a) and 2b).**

(4 marks)

(Total 13 marks)

QUESTION 3

Required:

a) **Given your responses to Questions 1 and 2, identify four major finance/treasury risks, *other than currency*, facing PPP Group in the medium term, with a brief one-sentence justification for each risk identified.**

(4 marks)

b) **What assumptions, quantified where possible, would you make about the extent of each risk in order to realistically stress test business plan forecasts? To what extent would you take correlation effects into account?**

(8 marks)

(Total 12 marks)

QUESTION 4

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

The modernisation and expansion of a pulp and paper mill, costing Euro 350 million, was financed by Euro 90 million export credit funding in euros and a Euros 260 million inter-company loan, funded from the group's euro syndicated credit facility, and lent in roubles. Of the 90 million export credit debt only 26 million is hedged locally, to contain the interest cost. This is in breach of Group Treasury Policy which states that subsidiaries should be 100% funded in, or hedged back to, local currency. For the phased draw-down of the inter-company loan, during the construction period, short-term FX swaps were used, to be rolled over on maturity, with a view to undertaking a longer-term amortising cross-currency interest rate swap to match the repayment profile on completion of the project. At the outset rouble and euro interest rates were very similar.

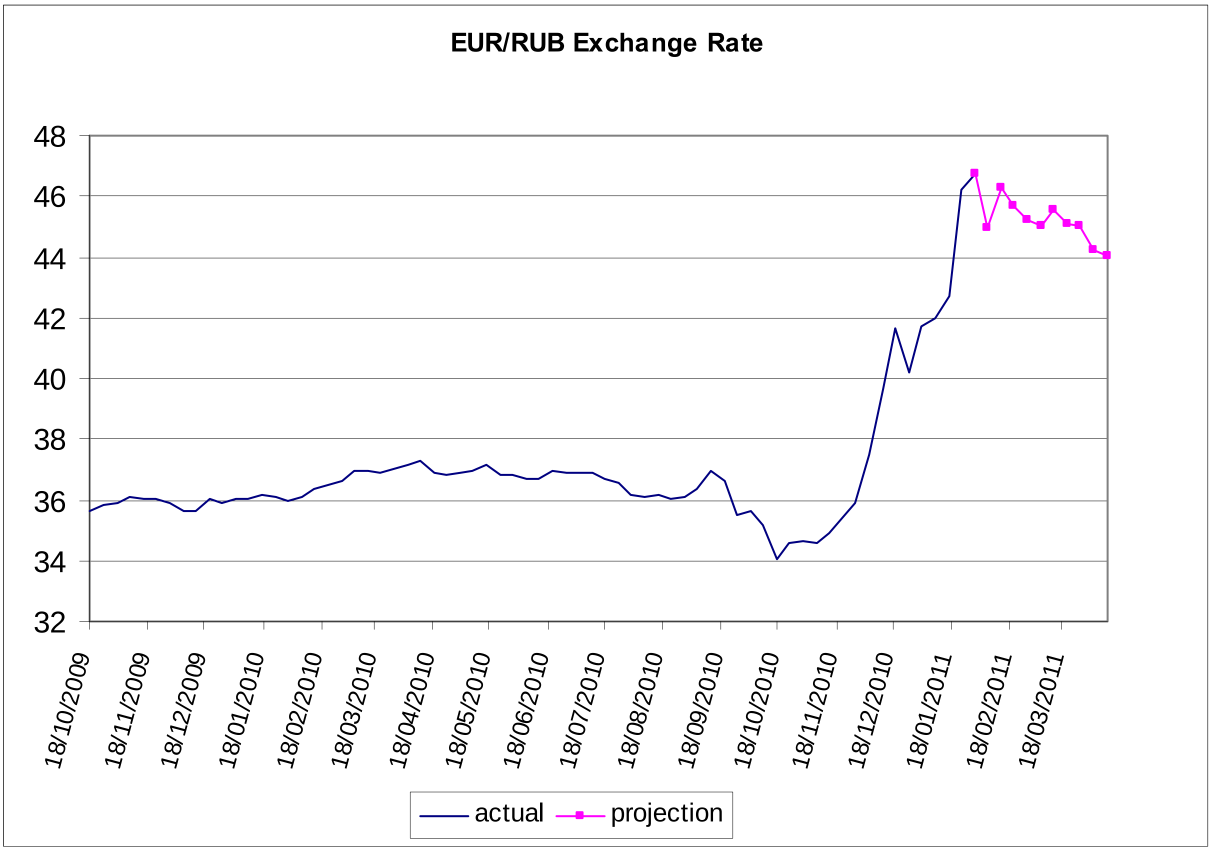
The project was scheduled to start in April 2010 and be completed in mid-2012, but problems with contractors and the unusually-severe weather in December 2010 led to disruption and delays in the construction work, but this is now progressing satisfactorily, if somewhat behind schedule. The majority of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

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

You have a table with details of the forecast covenant situation before the recent currency crisis broke, which was already a cause for concern. Note that the covenants were determined by the banks lending under the export credit facility.

Covenant Monitoring - PPP Russia

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



Required:

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

(5 marks)

b) **What impact is the current currency problem likely to have on the various covenants and how might this affect your proposed solutions in Question 4a)?**

(5 marks)

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

(5 marks)

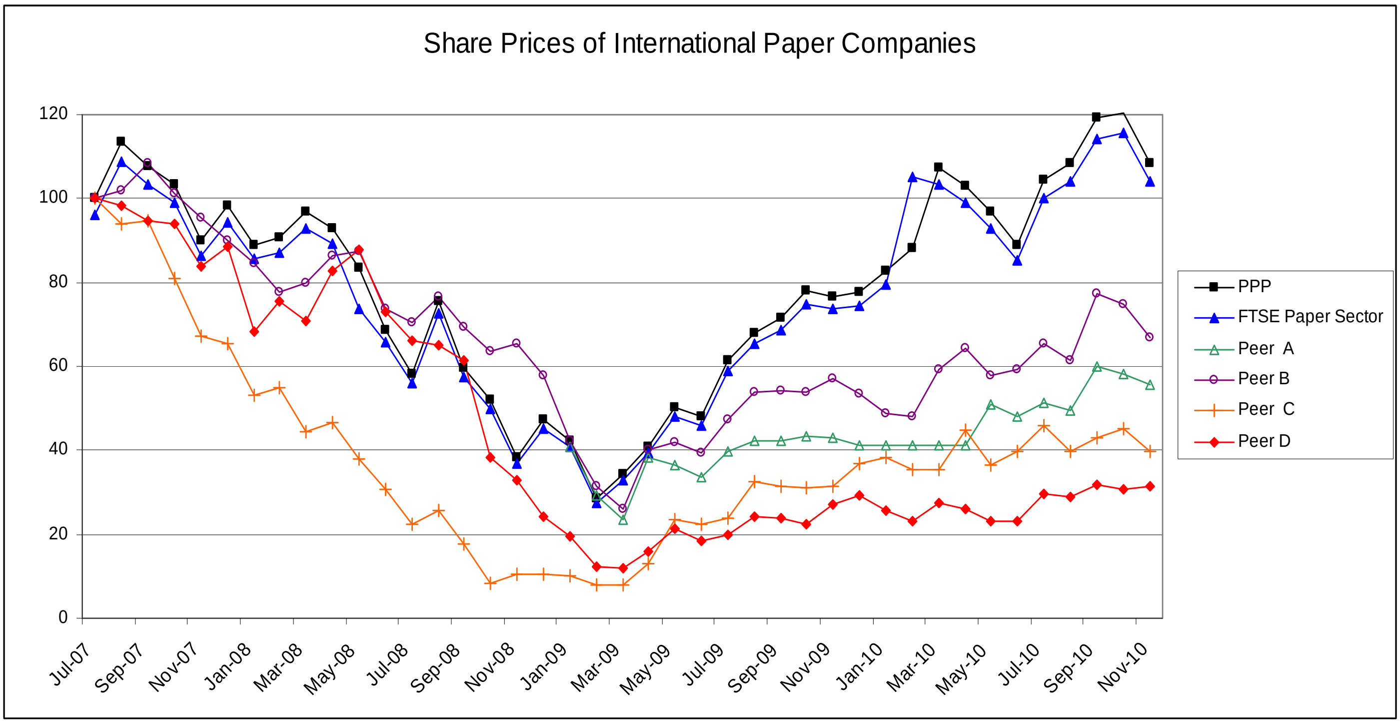
(Total 15 marks)

QUESTION 5

You have some comparative valuation multiples, taken from a recent broker's report for four selected companies in this sector based in Finland, South Africa, Canada and Ireland respectively, plus PPP as at 2010. You also have the valuation multiples for PPP plus PPP's cash flow statements since 2007, in the case study appendix. Finally you have a graph of the monthly share price movements for PPP since its listing in mid-2007, plotted against the UK Pulp & Paper Sector Index and the same international peer group companies.

Comparative Paper Company Multilples

	PPP 2010F	Peer A 2010F	Peer B 2010F	Peer C 2010F	Peer D 2010F	average
sales growth %	18.4	14.4	14.7	18.7	22.4	17.7
EBITA margin %	7.8	7.1	15.7	13.9	4.7	9.8
ROIC %	7.5	6.1	3.8	6.2	7.9	6.3
Dividend yield %	2.4	6.7	4.3	0.0	0.0	2.7
EV / Sales x	0.76	0.81	1.06	0.93	4.70	1.65
EV / EBITDA x	5.5	6.5	6.7	7.7	6.2	6.5
EV / Invested capital x	1.02	0.91	0.84	0.90	1.20	0.97
P/E x (normalised)	13.5	9.4	13.2	4.5	62.1	20.5



Required:

a) **Using the information provided on PPP and its peers to illustrate your discussion review the main company valuation methods, both DCF-based and multiples-based and in each case discuss the practical difficulties involved in valuing a company such as PPP. You are not asked to give an overall commentary on the valuation of PPP relative to its peers.**

(10 marks)

b) **Given your answer to 5a) what are the implications for PPP's management now that their declared current priority, following the listing and the subsequent strategic restructuring, is to focus on delivering returns to shareholders?**

(3 marks)

(Total 13 marks)

QUESTION 6

Required:

a) Explain briefly how the various types of currency risk arise in PPP Group.

(5 marks)

A subsidiary in the International Division buys paper intra-group in EUR, converts the paper into bags and sells in USD or in currencies pegged to USD.

The sales contracts are negotiated with customers annually and prices set for the coming calendar year. Individual customer annual requirements are naturally uncertain but, although not contracted to PPP on an “exclusive supplier” basis, customers have traditionally not switched supplier during the contract period.

The paper to satisfy the contracts is purchased from a fellow PPP subsidiary as required and paid for in EUR at a price set quarterly. Company policy is to hedge the accounts payable as orders are placed periodically throughout the year. In practice, this means that just a few weeks of supplies are hedged so the subsidiary selling the bags has a EUR/USD price-list exposure running throughout the calendar year. This means that the subsidiary has to negotiate contract prices aggressively in order to build in a buffer against EUR/USD volatility and so far there has been no noticeable impact on budgeted financial performance.

Now, however, the local Chief Executive has requested approval to hedge 80% of paper purchases one calendar year ahead, preferably at the start of negotiations, or, if not, when the contract is agreed. The subsidiary’s competitors also price in USD and customers will not accept a currency rate variation clause.

Required:

b) Comment on the pros and cons of the proposal.

(7 marks)

c) What would you recommend?

(2 marks)

PPP is exposed to translation risk.

Required:

d) What factors would you take into account in evaluating PPP’s translation exposure risk and what considerations would influence your response to managing that risk?

(4 marks)

(Total 18 Marks)

QUESTION 7

The EUR 1.5 billion Guaranteed Euro Medium Term Note Programme already in place provides a flexible basis for refinancing maturing debt. It is Q4 2010.

Required:

Given continuing uncertainty about future economic conditions, what factors would you take into account regarding the refinancing process?

(8 marks)

QUESTION 8

Required:

a) On the Treasury Organisation Matrix pro-forma provided create a profile for the current PPP treasury by ticking the cell in the top left hand corner of the appropriate box.

(2 marks)

b) Given what you have read about PPP in the case study and the views you have formed about the business while thinking through your answers to earlier questions, what profile would you wish to adopt for the medium term? Justify your choice.

(4 marks)

c) How would you organise the functional and geographic structure of treasury? For example what authorities would you retain at the centre and what would you delegate to divisions and individual subsidiaries, JVs?

(6 marks)

(Total 12 marks)

This pro-forma is available as a handout.

Treasury Organisation Profile

ROLE	Advisory	Agency	In-House Bank
AUTHORITIES	Decentralised	Centralised	Dynamic Balance
RESPONSE TO RISK	Cost Centre	Cost-Saving Centre	Profit Centre
ORGANISATION	Elementary	Intermediate	Advanced

CASE STUDY BACKGROUND INFORMATION

1.0 INTRODUCTION

PPP is an integrated paper and packaging group with revenue of €5.3 billion for the year ended 31 December 2009. It was demerged in mid 2007 from Global Commodities plc as part of a rationalisation process. Its key operations are located in Western Europe, Eastern Europe and Russia (“Emerging Europe”) and South Africa. PPP is principally involved in the manufacture of packaging paper, packaging products (including corrugated packaging and industrial bags), office paper and speciality products such as release liner, extrusion coating and consumer flexible packaging products. In addition, it has paper merchant operations which focus on Austria and Emerging Europe and newsprint operations in South Africa, the UK and Russia.

PPP is integrated across the paper and packaging production process from the growing of wood for pulp production and the manufacture of pulp and paper to the conversion of packaging papers into corrugated packaging, industrial bags and specialities.

PPP has production operations in approximately 101 production sites across 31 countries. The Group averaged approximately 31,000 employees during 2009.

Summary Financials

	2009 F/Y EUR mn	2010 H1 EUR mn
Turnover	5,257	3,033
EBIT	154	231
PAT	(3)	135
Net Debt	1,517	1,632
Shareholders’ Funds	2,824	3,093
Market Cap	1,331	2,599

The unaudited interim accounts to September 2010 show third quarter turnover marginally higher than that of the first two quarters, but with an improved operating profit. Cash flow enabled net debt to be reduced to Euros 1,536 at 30th September. "Following the completion of funding of our major capital projects in 2011, the Group will enter a period of increased cash flow generation. While focused growth still remains an option, the Group will allocate free cash flow to debt reduction and to improving cash returns to our shareholders".

2.0 PPP GROUP BUSINESS PROFILE

2.1 Origins of the Group

Group History

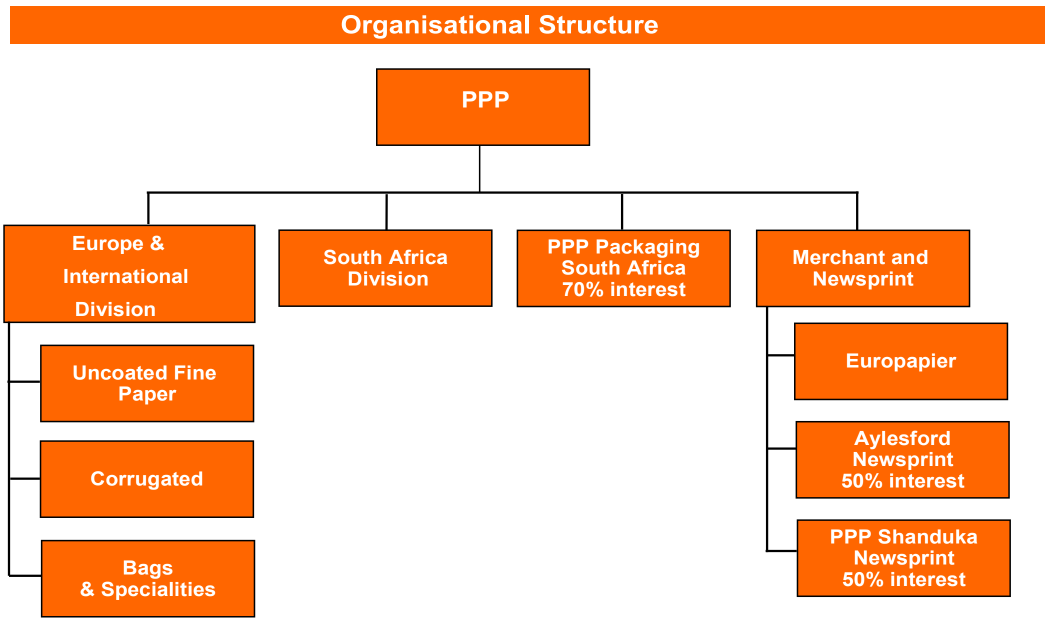
In the sixties Global Commodities plc founded PPP to build a paper mill near Durban in South Africa. In the early 1990s, PPP entered Europe with the acquisition of two Austrian based paper groups and subsequently expanded its operations through both acquisitions and organic growth to become one of the leading paper and packaging groups in Western Europe, Emerging Europe and Southern Africa.

In 2007, PPP was demerged from Global Commodities plc.

Following the demerger and with effect from 1 January 2008, the Group was reorganised into two primary divisions - the Europe & International Division and the South Africa Division. The remainder of the Group consists of the South African packaging business, PPP Packaging South Africa, and the Merchant and Newsprint business.

Business Structure

The following diagram shows the Group's current business structure:



2.2 Product-Market Overview

PPP products

PPP's core business is the manufacture of uncoated fine paper, packaging paper and converted packaging products, as well as speciality products.

Pulp

Both hardwood and softwood is produced largely for internal use. A total of 3.5 million tonnes was produced in 2009, with 0.4 million tonnes sold externally.

Uncoated fine paper (UFP)

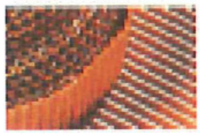
PPP is a leading European and South African producer of UFP, used for a wide range of office and professional printing paper for inkjet and laser printing. Well-known brands include color Copy, MAESTRO and IQ as well as the Russian Snegurochka and South African ROTATRIM brands.

Containerboard

A wide-ranging portfolio of corrugated case materials (virgin and recycled containerboard) is produced for corrugated box applications. To meet the corrugated industry's increasing demand for excellent lightweight liners and flutings, PPP has invested in the construction of one of the world's fastest containerboard machines (1,800m/min) in Poland.

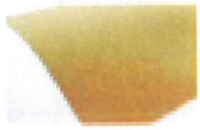
Corrugated boxes

PPP is a leading supplier of all forms of corrugated packaging, including conventional boxes and trays of all shapes and sizes, point of sales displays, Shelf-Ready Packaging (SRP) and heavy duty packaging. Radio Frequency Identification (RFID) enabled corrugated cases are an integral part of the Group's portfolio



Kraft paper

Kraft papers within the advantage range are widely used, from specialist packaging and heavy-duty industrial applications (including building and chemicals) to consumer packaging (including food and pet food) a wide range of grades is offered, each catering to the specific requirements of different packaging concepts.

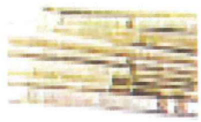


Industrial bags

PPP is the world's largest producer of industrial bags and offers a wide variety, including ultra-strong and air-permeable bags with sophisticated closure techniques. These products are used to package, among other things, cement, chemicals, seeds, animal feed, flour and milk powder, as well as automotive parts and organic and bio-waste.

Specialties

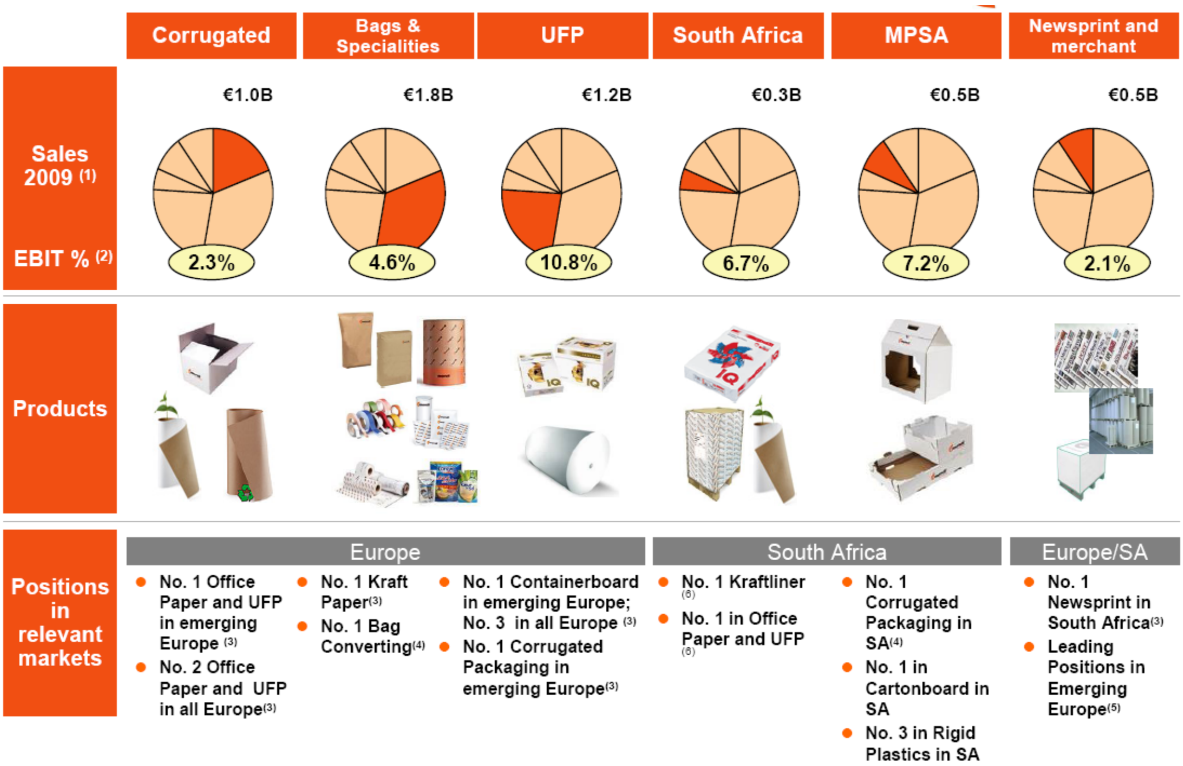
These are high-quality products such as extrusion coating products, release liners, consumer bags and pouches. The Groups expertise in extrusion coating, laminating, siliconising and printing enables PPP to offer customised products for the food, pet food, building, medical and hygiene industries among others. Sanocoat, an anti-microbial packaging solution for increased shelf-life, is a recent innovation.



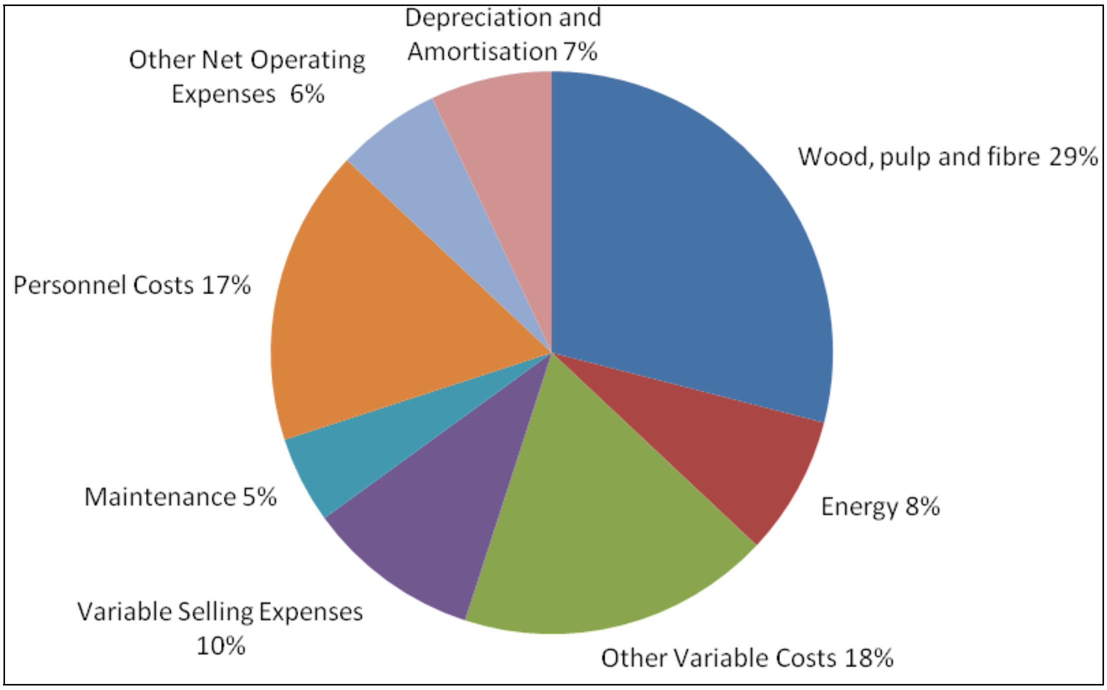
Newsprint

PPP is a small producer of newsprint and telephone directory paper, manufactured in South Africa, Russia and the UK.

PPP Summary Product-Markets



Cost Structure 2009



PPP is largely self-sufficient in energy because the paper-making process produces heat which can be recycled to generate electricity.

PPP Operating Sites

Operations – Europe and Russia

Austria	Netherlands	Poland
Belgium	Spain	Russia
Finland	Sweden	Serbia
Germany	UK	Slovakia
Greece	Czech Republic	Turkey
Italy	Hungary	Ukraine

Operations – Africa

Morocco	South Africa
Mozambique	Zimbabwe
Namibia	

Operations – International

Israel	Malaysia	USA
Jordan	Mexico	
Lebanon	Oman	

2.3 Group Strategy

Three Key Pillars

To quote an equity analyst:

. . . *"since before the spin out in 2007, PPP has been following a consistent strategy with 'three key pillars':*

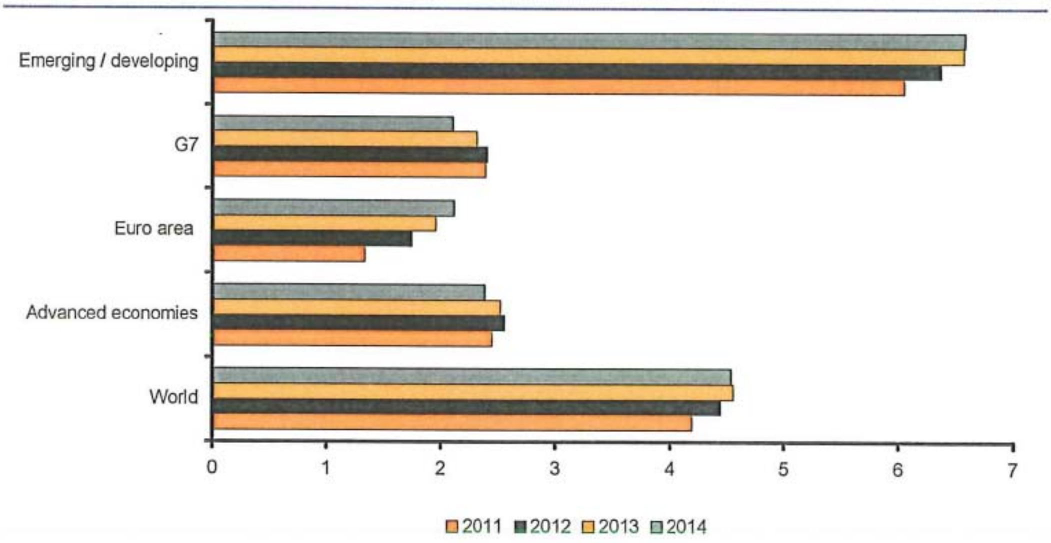
- ***Build leading market positions:*** *build on leading positions in packaging and uncoated fine paper, particularly in emerging markets*
- ***Maintain high quality, low cost asset base:*** *PPP aims to be the lowest cost producer in its selected markets, by selectively investing in production capacity in lower cost regions, and exploiting the benefits of its upstream integration (including forestry).*
- ***Focus on performance:*** *focus on continuous productivity improvement and cost reduction, delivered through business excellence programmes and rigorous asset management.*

In summary, PPP is focusing on emerging markets, low cost production with an integrated value chain including forestry, continual performance improvement and market leadership positions.

Global Demand Growth in Paper

Strategically, PPP has focused its investment in emerging economies such as Russia and Poland, with their superior GDP growth rates leading to increased demand for paper relative to more mature western European economies (which are witnessing declining demand for some grades of paper).

Chart 1 : IMF real GDP growth forecasts



Source: IMF

We view GDP growth as the key long-term determinant of paper demand growth. As can be seen in Chart 1, the IMF forecast of between 6% and 7% GDP growth pa in emerging / developing economies in 2011-14 compares to typically 1-2% growth from the Euro area.

Pulp & paper market researchers forecast a 5.7% CAGR growth in Russian & Eastern European fine paper demand (UFP) from 2009 to 2015, and 9.1% growth in kraftliner and testliner over the same period. They estimate long-term demand growth rates of 5% in Emerging Europe compared with long-term growth rates of 2% pa in Western Europe - this is consistent with IMF GDP growth forecasts above.

Other paper sector researchers anticipate 7% global demand growth for paper in calendar 2010 (split + 5% in the developed world and + 9% in the developing world)".

Table 1 : Global demand growth for paper

Year	*Global*	*Developed World*	*Developing World*
2010	*+7.0%*	*+5.0%*	*+9.0%*
2011	*+3.0%*	*+0.0%*	*+6.0%*

Three-quarters of PPP's operating assets are in emerging markets.

Market Dynamics
The market for paper is cyclical rather than seasonal. Paper making (in contrast to converting eg to bags) is very capital intensive, individual paper-making machines are large, take several years to plan and install/modernise and create a step change in capacity. So there is a tendency to overcapacity as manufacturers invest to catch up with demand and are overtaken by the next downturn.

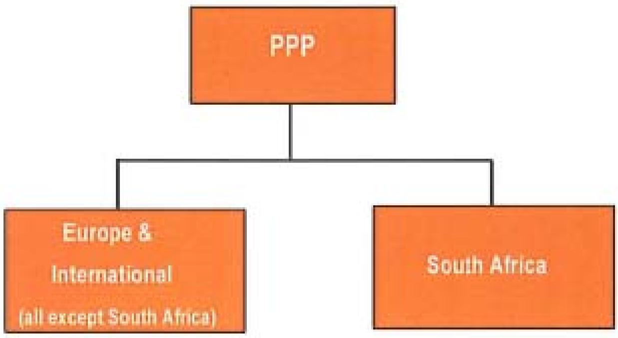
Timber, the raw material, is not uniformly available across the world for climatic and demographic reasons. In cold climates (Scandinavia, Russia) growth rates are slow whereas in warmer climates (South Africa) they are much faster. Timber is in relatively short supply in Scandinavia, a traditional provider of wood pulp, whereas in Russia supply is abundant.

Relative exchange rates (not surprisingly) can influence paper product trading patterns significantly. For example, paper exports from South Africa to neighbouring countries may become uncompetitive if the Rand appreciates but pulp may still be a viable export.

Domestic supply-demand imbalances are also significant. For instance, if demand outstrips supply in Russia, paper has to be imported from more expensive external sources. This enables Russian domestic manufacturers to increase prices if the RUB weakens.

2.4 Treasury and Finance

Treasury



- South Africa is funded locally. There is a Treasury Manager but the dealing activity is outsourced.
- For the rest of the Group the funding and risk management are executed from London where the Group Treasurer is based with three staff.
- There are no Treasurers in any of the subsidiaries. For instance London acts on an agency basis for Russia.
- There are four cash management staff in Vienna. Pre the de-merger, Vienna was the main financial centre outside South Africa.
- The Chief Financial Officer favours a centralised approach to treasury.

Finance

In H1 2010, PPP established a Guaranteed Euro Medium Term Note Programme for EUR 1.5bn in anticipation of refinancing existing facilities.

Miscellaneous Data

Note that the PPP shares opened at 500p (Euro 7.41) on the first day of trading in July 2007. Since that date the company, the industry and the whole stock market suffered as a result of the banking crisis and recession, as the following table shows.

Share Price Information

		Jul-07	Nov-07	Apr-08	Nov-08	Mar-09	Oct-09	Feb-10	Oct-10	open 01/11/2010	close 02/12/2010
Company share price (GBP pence)	year's high	500		447			362		562	**529**	**469**
	year's low		365		125	118		334			
FTSE Forestry & paper Index	year's high	5380		4809			3896		6053	**5698**	**5149**
	year's low		3932		1354	1284		3599			
Company share price (GBP pence), relative to July '07		1.000		0.894			0.724		1.124	1.058	0.938
			0.730		0.250	0.236		0.668			
FTSE Forestry & paper Index, relative to July '07		1.000		0.894			0.724		1.125	1.059	0.957
			0.731		0.252	0.239		0.669			
Company Share Price x 10 / Forestry Index		0.929	0.928	0.930	0.923	0.919	0.929	0.928	0.928	0.928	0.911

Analysts's forecasts for 2010, 2011 full year results for PPP

	2010 low	2010 average	2010 high	2011 low	2011 average	2011 high
Sales (Euro millions)	5,810	6,060	6,220	5,880	6,270	6,500
EPS (cents)	38	44	50	50	58	73

Relatively few paper-making firms are investment grade.

2.5 Debt and Leasing

Borrowings

€ million	2009 Current	2009 Non-current	2009 Total	2008 Current	2008 Non-current	2008 Total
Secured						
Bank loans and overdrafts	54	127	181	63	140	203
Other loans	1	1	2	–	–	–
Obligations under finance leases	4	16	20	4	20	24
Total secured	**59**	**144**	**203**	67	160	227
Unsecured						
Bank loans and overdrafts	159	1,144	1,303	298	1,124	1,422
Other loans	1	133	134	13	183	196
Total unsecured	**160**	**1,277**	**1,437**	311	1,307	1,618
Total borrowings	**219**	**1,421**	**1,640**	378	1,467	1,845

Obligations under finance leases

The maturity of obligations under finance leases is:

€ million	2009	2008
Not later than one year	5	5
Later than one year but not more than five years	11	14
More than five years	8	12
Future value of finance lease liabilities	**24**	31
Future finance charges	(4)	(7)
Present value of finance lease liabilities	**20**	24

Financing facilities

Group liquidity is provided through a range of committed debt facilities which are in excess of the Group's short-term cash needs. The principal loan arrangements in place include the following:

€1.55 billion Syndicated Revolving Credit Facility (UKRCF)

The UKRCF is a five year multi-currency revolving credit facility which was signed on 22 June 2007. This facility was initially drawn down to refinance existing debt obligations outstanding to the Global Commodities plc group prior to demerger. Interest is charged on the balance outstanding at a market-related rate linked to LIBOR.

€170 million Export Credit Agency Facility (ECAF)

The ECAF is used to part finance expansionary capital expenditure in Russia. The facility has an amortising repayment until 2020 and interest is charged on the balance outstanding at a market-related rate linked to LIBOR.

€115 million European Investment Bank Facility (EIBF)

The EIBF is used to part finance expansionary capital expenditure in Poland. The facility has an amortising repayment until 2017 and interest is charged at a fixed rate of interest.

In addition to the facilities above, the Group has committed facilities amounting to South African Rand 3.6 billion in South Africa.

Maturity profile of outstanding financial liabilities

Maturity profile of outstanding financial liabilities

2009/€ million	< 1 year	1-2 years	2-5 years	5+ years	Total[1]
	Undiscounted cash flows				
Trade and other payables	1,023	–	–	–	1,023
Finance leases	6	4	7	7	24
Borrowings	284	321	1,007	170	1,782
Total	**1,313**	**325**	**1,014**	**177**	**2,829**

2008/€ million	< 1 year	1-2 years	2-5 years	5+ years	Total
	Undiscounted cash flows				
Trade and other payables	1,035	–	–	–	1,035
Finance leases	7	6	9	9	31
Borrowings	389	124	1,213	178	1,904
Total	1,431	130	1,222	187	2,970

Currency and interest basis

2009/€ million	Cash & Equivalent	Floating rate borrowings	Fixed rate borrowings	Non-interest bearing borrowings	Total carrying value	Fair value
Euro	34	817	164	1	982	983
South African rand	39	342	48	12	402	402
Sterling	3	10	-	-	10	10
US dollar	7	4	6	-	10	11
Polish zloty	2	51	115	-	166	150
Czech koruna	2	46	-	-	46	46
Other currencies	36	15	9	-	24	23
Carrying value	**123**	**1,285**	**342**	**13**	**1,640**	
Fair value		**1,285**	**327**	**13**		**1,625**

2008/€ million	Cash & Equivalent	Floating rate borrowings	Fixed rate borrowings	Non-interest bearing borrowings	Total carrying value	Fair value
Euro	56	996	256	2	1,254	1,248
South African rand	22	338	38	11	387	387
Sterling	8	7	-	-	7	7
US dollar	19	11	25	-	36	38
Polish zloty	12	2	47	-	49	49
Other currencies	38	86	26	-	112	113
Carrying value	155	1,440	392	13	1,845	
Fair value		1,440	390	12		1,842

2.6 Segmental Analysis

Operating Revenues

The Group's external revenues for each type of product are presented as follows:

€ million	**2009**	2008
Products		
Corrugated products	1,357	1,849
Uncoated fine paper	1,195	1,313
Kraft paper & bags	886	1,066
Specialities	731	854
Merchanting	468	487
Newsprint	208	162
Pulp	129	160
Woodchips	61	105
Other	222	349
Group total	**5,257**	6,345

An analysis of the Group's external revenues attributed to the countries, where material, and the continents in which external customers are located, is presented as follows:

€ million	**2009**	2008
Revenues		
Africa		
South Africa	644	616
Rest of Africa	196	251
Africa total	840	867
Western Europe		
Germany	641	745
United Kingdom	367	483
Rest of Western Europe	1,292	1,704
Western Europe total	2,300	2,932
Emerging Europe	1,105	1,326
Russia	387	430
North America	157	183
South America	17	31
Asia and Australia	451	576
Group total	**5,257**	6,345

An analysis of the Group's external revenues attributed to the countries, where material, and the continents from which revenues are derived, is presented as follows:

€ million	2009	2008
Revenues		
Africa		
South Africa	948	1,015
Rest of Africa	13	15
Africa total	961	1,030
Western Europe		
Austria	1,010	1,226
United Kingdom	244	344
Rest of Western Europe	855	1,202
Western Europe total	2,109	2,772
Emerging Europe	1,413	1,691
Russia	519	569
North America	104	120
Asia and Australia	151	163
Group total	**5,257**	6,345

There are no external customers which account for more than 10% of the Group's total external revenue.

Operating segment operating profit / (loss)

Segment operating profits/(losses) are presented, and reconciled to Group profit/(loss) before tax, as follows:

	Segment operating profit/(loss) before special items		Segment operating profit/(loss) after special items	
€ million	2009	2008	2009	2008
Europe & International				
Uncoated Fine Paper	146	126	144	98
Corrugated	23	49	(27)	(62)
Bags & Specialities	82	159	34	(58)
Total Europe & International	251	334	151	(22)
South Africa				
Uncoated Fine Paper	16	75	(6)	75
Containerboard	16	36	16	36
Total South Africa	32	111	10	111
PPP Packaging South Africa	36	28	43	28
Merchant & Newsprint businesses	12	7	–	7
Corporate & other businesses	(37)	(39)	(38)	(41)
Segments total	**294**	441	**166**	83
Net profit/(loss) on disposals	–	–	3	(27)
Impairment of assets held for sale	–	–	(8)	(2)
Net income from associates	2	2	2	2
Net finance costs	(114)	(159)	(114)	(159)
Group profit/(loss) before tax from continuing operations	**182**	284	**49**	(103)

Segment assets and liabilities

Segment assets, liabilities and net assets are presented, and reconciled to their respective Group totals, as follows:

€ million	2009 Segment assets	2009 Segment liabilities	2009 Net segment assets	2008 Segment assets	2008 Segment liabilities	2008 Net segment assets
Europe & International						
Uncoated Fine Paper	1,671	(177)	1,494	1,589	(177)	1,412
Corrugated	1,071	(199)	872	1,171	(241)	930
Bags & Specialities	1,531	(309)	1,222	1,632	(315)	1,317
Intra-segment elimination	(33)	33	–	(76)	76	–
Total Europe & International	4,240	(652)	3,588	4,316	(657)	3,659
South Africa						
Uncoated Fine Paper	804	(92)	712	720	(80)	640
Containerboard	150	(22)	128	139	(19)	120
Intra-segment elimination	(6)	6	–	(2)	2	–
Total South Africa	948	(108)	840	857	(97)	760
PPP Packaging South Africa	432	(97)	335	371	(70)	301
Merchant & Newsprint businesses	263	(69)	194	283	(87)	196
Corporate & other businesses	3	1	4	13	(3)	10
Inter-segment elimination	(74)	74	–	(101)	101	–
Segments total	**5,812**	**(851)**	**4,961**	5,739	(813)	4,926
Unallocated:						
Investment in associates	6	–	6	5	–	5
Deferred tax assets/(liabilities)	29	(316)	(287)	36	(292)	(256)
Other non-operating assets/(liabilities)	211	(577)	(366)	307	(615)	(308)
Group trading capital employed	**6,058**	**(1,744)**	**4,314**	6,087	(1,720)	4,367
Financial asset investments	27	–	27	19	–	19
Net debt	123	(1,640)	(1,517)	155	(1,845)	(1,690)
Group net assets	**6,208**	**(3,384)**	**2,824**	6,261	(3,565)	2,696

3.0 FINANCIALS

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

Equity Analysis Model
PPP Group plc
Income Statement

		Historical Data			
	Accounts date	**2007**	**2008**	**2009**	**2010**
	Currency / units	**Euro mill**	**Euro mill**	**Euro mill**	**Euro mill**
	Audit / man / fcst	**audited**	**audited**	**audited**	**audited**
	Number of months	**12**	**12**	**12**	**6**
	Sales Revenue	**6,269**	**6,345**	**5,257**	**3,033**
a	(Cost of Sales)	(3,823)	(3,926)	(3,240)	(1,901)
a	**Gross Profit**	**2,446**	**2,419**	**2,017**	**1,132**
a	(Total Overheads)				
a	Other Operating (Costs) & Revenues				
a	Exceptionals etc. +/-				
b	Cost of Materials, Other External Purchases				
b	**Value Added**				
b	(Personnel Costs)	(906)	(926)	(838)	(458)
b	(Depreciation & Impairment of Tangible Assets)	(363)	(364)	(341)	(178)
b	(Amortisation of Intangibles excl. Goodwill)	(5)	(9)	(10)	(5)
b	(R&D Costs)				
b	Other Operating (Costs) & Revenues	(670)	(679)	(534)	(269)
b	Exceptionals etc. +/-	(77)	(358)	(128)	36
	Operating Profit	**425**	**83**	**166**	**258**
	Non-operating Income & Expenditure				
	Exceptionals etc.	54	(29)	(5)	(35)
	(Amortisation of Goodwill)				
	Financial Income				
	Income from Investments, Participations etc	2	2	2	2
	Other Financial Income & Expenditure	(2)	(36)	(9)	6
	EBIT	**479**	**20**	**154**	**231**
	Interest Received & Paid				
	Interest Received	24	23	9	8
	(Gross Interest Paid)	(121)	(146)	(114)	(62)
	Profit before Tax	**382**	**(103)**	**49**	**177**
	(Current tax)	(117)	(78)	(52)	(42)
	(Deferred tax)				
	Profit after Tax	**265**	**(181)**	**(3)**	**135**
	Extraordinaries, (amortisation of goodwill) etc	15			
	Minority Interests	(47)	(30)	(30)	(26)
	(Preference Dividends)				
	Net Income / Earnings for Ordinary Shareholders	**233**	**(211)**	**(33)**	**109**
	(Ordinary Dividends)	(118)	(118)	(39)	(36)
	Retained Profit for Year	**115**	**(329)**	**(72)**	**73**
	Statement of Gains and Losses		(309)	146	170
	Income after gains and Losses	280	(490)	143	305

EBITA (before exceptionals & Goodwill Amort.)	**502**	**407**	**287**	**230**
EBITDA (before Exceps. Deprn, & all Amortisn.)	**870**	**780**	**638**	**413**
Cash Earnings (Before Goodwill, Exceps.& Extraords)	**241**	**176**	**100**	**108**
Cash Retained Profit (Before Goodwill, Exceps & Extraords)	**123**	**58**	**61**	**72**

Equity Analysis Model
PPP Group plc
Balance Sheet

	Historical Data			
Accounts date	**2007**	**2008**	**2009**	**2010**
Currency / units	**Euro mill**	**Euro mill**	**Euro mill**	**Euro mill**
ASSETS				
Fixed Assets				
Intangible Fixed Assets	520	323	308	314
Property, Land & Buildings, Forestry Assets - net	1,090	1,000	1,149	1,188
Other Fixed Assets - net	2,865	2,825	2,949	3,092
Financial Investments, Tax & Pension Assets & Derivatives	74	60	70	83
Medium-term Trade-related Assets				
Total Fixed Assets	**4,549**	**4,208**	**4,476**	**4,677**
Current Assets				
Stocks, Inventories, Work in Progress	760	684	617	688
Debtors, Prepayments, Receivables etc.	1,304	1,104	933	1,083
Cash and Short-term Investments	180	155	123	77
Tax Assets, Derivatives & Other Current Assets	69	110	59	204
Total Current Assets	**2,313**	**2,053**	**1,732**	**2,052**
Total Assets	**6,862**	**6,261**	**6,208**	**6,729**
LIABILITIES				
Current Liabilities (Creditors < 1 Year)				
Creditors, Accruals, Advance Payments etc.	1,150	1,035	1,023	1,123
Short-term Debt	453	378	219	217
Corporation Tax Payable	81	53	55	75
Provisions, Derivatives & Other Current Liabilities	17	66	81	114
Total Current Liabilities	**1,701**	**1,532**	**1,378**	**1,529**
Non-current Liabilities (Creditors > 1 Year)				
Medium & Long-term Debt	1,234	1,467	1,421	1,492
Medium-term Trade-related Liabilities	19	14	21	21
Deferred Tax, Pension & Other Long-term Provisions	572	552	564	594
Total Non-current Liabilities	**1,825**	**2,033**	**2,006**	**2,107**
Share Capital & Reserves				
Issued Share Capital	114	114	114	114
Share Premium Account, Treasury Shares	532	532	532	532
Revaluation Reserve				
Other Reserves				
Retained Earnings / Profit and Loss	2,317	1,677	1,753	2,006
Total Capital and Reserves	**2,963**	**2,323**	**2,399**	**2,652**
Minority Interests	373	373	425	441
Total Shareholders' Funds	**3,336**	**2,696**	**2,824**	**3,093**
Accumulated depreciation	3,808	3,820	4,092	4,092

Equity Analysis Model

PPP Group plc

UK-Style Cash Flow Statement

	Historical Data			
Accounts date	**2007**	**2008**	**2009**	**2010**
Currency / units	**Euro mill**	**Euro mill**	**Euro mill**	**Euro mill**
Number of months	**12**	**12**	**12**	**6**
CASH FLOW FROM OPERATING ACTIVITIES				
Operating Profit	425	83	166	258
Tangible Asset Depreciation	363	364	341	178
Dec(Inc) in Stock / Inventories	(69)	26	80	(64)
Dec(Inc) in Debtors / Receivables	25	106	170	(192)
Inc(Dec) in Creditors / Payables & Advance Payments	141	(105)	(2)	115
All other non-cash adjustments & Exceptionals	72	321	112	(26)
Cash Generated from Operations	**957**	**795**	**867**	**269**
Dividends Received from Associates	1	2	2	2
Tax Paid	(93)	(71)	(32)	(36)
Net Cash from Operating Activities	**865**	**726**	**837**	**235**
CASH FLOW FROM INVESTING ACTIVITIES				
Dividends Received from Investments	(3)	9	99	(61)
Interest Received	18	28	8	4
(Purchase of Tangible Fixed Assets)	(406)	(693)	(517)	(184)
Disposal of Tangible Fixed Assets	17	29	11	6
(Purchase of Subs, Intang., Financial & Forestry Assets)	(240)	(101)	(54)	(31)
Disposal of Subsidiaries, Intangibles & Financial Assets	183	19	59	77
Net Cash from Investing Activities	**(431)**	**(709)**	**(394)**	**(189)**
CASH FLOW FROM FINANCING ACTIVITIES				
(Total Interest Paid)	(139)	(169)	(163)	(60)
New Shares Issued	120			
(Repurchase / Redemption of Shares)	(33)	(15)	(1)	(1)
(Costs of Issuing / Redeeming Equity)				
Total Increase in Debt	564	543	38	527
(Total Decrease in Debt)	(945)	(214)	(288)	(547)
(Dividends Paid on Ordinary Shares)	(240)	(118)	(39)	(36)
(Preference and Minority Dividends Paid)	(47)	(20)	(9)	(17)
Movements Relating to Derivative Instruments				
Net Cash from Financing Activities	**(720)**	**7**	**(462)**	**(134)**
Net Cash Flow from Ops. Investing & Funding	(286)	24	(19)	(88)
Balance check	-	-	-	-

Change in Cash	-	(25.0)	(32.0)	(46.0)
Change in Overdraft	(286.0)	49.0	13.0	(42.0)

Equity Analysis Model
PPP Group plc
Share Price Data

	Historical Data			
Accounts date	**2007**	**2008**	**2009**	**2010**
Currency / units	**Euro mill**	**Euro mill**	**Euro mill**	**Euro mill**
	12	**12**	**12**	**6**
Number of Shares & Eps				
Adjusted Earnings per Share (pence or equivalent)	45.40	(41.60)	(6.50)	21.50
Dividends Per Share (pence or equivalent)	23.00	12.70	9.50	3.50
Average number of common shares	513.0	507.0	508.0	508.0
Share Prices				
Common Share Price - Low (pounds or equivalent)	5.16	1.51	1.29	3.82
Common Share Price - High (pounds or equivalent)	8.27	5.62	3.95	6.42
Common Share Price - Average	6.72	3.56	2.62	5.12
Risk rating				
Variability %		44	52	51
Beta (actual or estimate)	1.08	1.08	1.33	1.33
Market Capitalisation				
Market Capitalisation - Common Stock	3,446	1,807	1,331	2,599
Market Capitalisation - Preference Stock	-	-	-	-
Market Capitalisation - Total	3,446	1,807	1,331	2,599
Minorities	373	373	425	441
Net Debt	1,507	1,690	1,517	1,632
Enterprise value [EV]	**5,326**	**3,870**	**3,273**	**4,672**

Equity Analysis

Equity Ratios				
Eps Growth %	198.7%	(191.6%)	84.4%	n.a
P/E Ratio	14.8			11.9
Market / Book Ratio	1.16	0.78	0.55	0.98
Dividend Cover	1.97	(3.28)	(0.68)	6.14
Dividend Yield %	3.4%	3.6%	3.6%	2.1%
Total Return to Shareholders %		(43.4%)	(22.9%)	192.7%
EV Valuation Multiples				
EV / Sales	0.85	0.61	0.62	0.77
EV / Total Assets	0.78	0.62	0.53	0.69
EV / EBITA	10.61	9.51	11.40	10.16
EV / EBITDA	6.12	4.96	5.13	5.66
EV / Sustainable Free Cash Flow	24.1	14.4	19.2	36.0

Equity Analysis Model

PPP Group plc

Cash Flow Analysis

	Historical Data				
Accounts date	**2007**	**2008**	**2009**	**2,010**	**Period**
Currency / units	**Euro mill**	**Euro mill**	**Euro mill**	**Euro mill**	**Total**
Cash Flow Summary	**audited**	**audited**	**audited**	**audited**	
Number of months	**12**	**12**	**12**	**6**	
CASH FLOW FROM OPERATIONS					
Operating Profit	425	83	166	258	932
Other Non-cash & Exceptional Items	72	321	112	(26)	479
Investment Income	(2)	11	101	(59)	51
"Cash Profit"	**495**	**415**	**379**	**173**	**1,462**
(Increase) / Decrease in Net Working Assets	97	27	248	(141)	231
Tangible Asset Depreciation	363	364	341	178	1,246
Net Capital Expenditure	(389)	(664)	(506)	(178)	(1,737)
(Tax Paid	(93)	(71)	(32)	(36)	(232)
(Dividends Paid)	(287)	(138)	(48)	(53)	(526)
Free Cash Flow before Interest	**186**	**(67)**	**382**	**(57)**	**444**
(Net Interest Paid)	(121)	(141)	(155)	(56)	(473)
Internal Cash Flow	**65**	**(208)**	**227**	**(113)**	**(29)**
ACQUISITION & FINANCING CASH FLOWS					
(Acquisitions),Disposals,(Investments)	(57)	(82)	5	46	(88)
Increase / (Decrease) in Share Capital	87	(15)	(1)	(1)	70
Increase / (Decrease) in Debt	(95)	280	(263)	22	(56)
(Increase) / Decrease in Cash		25	32	46	103
Net Financing Cash Flow	**(65)**	**208**	**(227)**	**113**	**29**

Equity Analysis Model
PPP Group plc
Financial Profile

	Historical Data			
Accounts date	**2007**	**2008**	**2009**	**2010**
Number of months	**12**	**12**	**12**	**6**
Annual % Growth Rates				
Sales Growth	9.0%	1.2%	(17.1%)	15.4%
Gross Profit Growth	9.5%	(1.1%)	(16.6%)	12.2%
Operating Profit Growth	42.1%	(80.5%)	100.0%	210.8%
EBITA Growh	59.4%	(18.9%)	(29.5%)	60.3%
Net Earnings Growth before Exceps & Extraords.	73.4%	(27.0%)	(43.2%)	116.0%
Profitability and Cost Structure				
Gross Profit % Sales	39.0%	38.1%	38.4%	37.3%
Overheads % Sales	31.0%	31.1%	32.7%	29.9%
Exceptional & Other Financial Items % Sales (+/-)	(0.4%)	(6.7%)	(2.7%)	0.2%
EBIT % Sales	7.6%	0.3%	2.9%	7.6%
Personnel Costs % Sales	14.5%	14.6%	15.9%	15.1%
Depreciation % Sales	5.8%	5.7%	6.5%	5.9%
EBITA % Capital Employed (pre-exceptionals)	10.4%	9.3%	6.6%	9.7%
Pre-tax Target Rate of Return (market values)	11.4%	11.3%	11.7%	12.6%
EBITA % Market Enterprise Value	9.4%	10.5%	8.8%	9.8%
Asset Utilisation / Capital Intensity				
Sales / Total Assets	0.91	1.01	0.85	0.90
Stocks % Sales	12.1%	10.8%	11.7%	11.3%
Debtors % Sales	20.8%	17.4%	17.7%	17.9%
Creditors & Advance Payments % Sales	18.6%	16.5%	19.9%	18.9%
Net Working Assets % Sales	14.3%	11.6%	9.6%	10.3%
Tangible Fixed Assets % Sales	63%	60%	78%	71%
Depreciable Assets % Sales	46%	45%	56%	51%
Net Capex % Annual Depreciation	107%	182%	148%	100%
Average Age of Depreciable Assets (years)	10.49	10.49	12.00	11.49
Tax Ratios				
Effective Interest Rate [P&L] %	14.3%	8.3%	6.5%	7.4%
Effective Tax Rate [P&L] %	30.6%	(75.7%)	106.1%	23.7%
Cash Tax Rate [Cash Flow] %	24.3%	(68.9%)	65.3%	20.3%

Equity Analysis Model
PPP Group plc

Capital Structure & Credit Status	**2007**	**2008**	**2009**	**2010**
Balance Sheet Gearing & Leverage				
Leverage: (Net Debt % Capital Employed)	31%	39%	35%	35%
Net Debt % Enterprise Value	28%	44%	46%	35%
Interest Cover Ratios				
Interest Cover: (EBITA / Net Interest Paid)	9.0	6.3	6.1	7.6
Cash Flow before Interest / Cash Net Interest	1.5	(0.5)	2.5	(1.0)
Income Leverage (Debt Repayment Ability)				
Net Debt / Retnd. Profit + Goodwill Amort.(years to repay)	12.3	29.1	24.9	11.3
Net Debt / EBITDA	1.7	2.2	2.4	2.0

CASE STUDY EXAMINATION - NOTE FORM ANSWERS

QUESTION 1 **16.2 mins (Total 9 marks)**

Required:

a) **Using whatever concepts and tools of analysis that you consider appropriate carry out an assessment of the company's strategic and operating environment, with the emphasis on assessing factors relevant to delivering shareholder value on a consistent basis. Shareholder value is the company's current priority following recent years' focus on the buy-out, listing, and subsequent strategic re-positioning.**

12.6 mins (7 marks)

Marking scheme - I have 30 points so ¼ mark for each good point made.

Shareholder value is driven by stable, [1] growing [2] profits and cash flow [3] , so relevant factors are those affecting risk, profits, working capital, capex, tax [4]

I expect the candidates to use the following and explore / demonstrate their usefulness;

PEST; [5] on the whole a challenging [6] business environment, especially because of P and E [7] factors, not so much S and T e.g. commodity prices, [8] exchange rates, cyclical [9] industry based on GDP-driven [10] demand for paper, long [11] investment cycle, capital [12] intensive business, lower-cost production in [13] emerging markets, environmental/green [14] issues, political risks [15] South Africa, Russia.

Porter; [16] supplier [17] power reduced by backward vertical integration and long-term supply contracts. Competition and paper as a commodity means high buyer [18] power, again modified [19] by long-term relationships, competitive costs and pricing, and customised service. Threat of new entrants not big [20] – very capital intensive and access to forest resources are big entry barriers. Threat of substitutes – no immediate short-term threat [21] to paper products' multitude of applications but longer-term threat. Structure of competition [22] – a few big global players, but PPP one of biggest, lots of smaller local players competing in particular geographical markets. [23]

Product/Market Life Cycle; A mature product and mature market [24] in developed world, but PPP well established in faster growing markets [25] in emerging economies, except South America.

Environments Matrix; [26] ("stalemate" struggling [27] to be "volume"?)
Key issues will be global business locally integrated vertically to reduce [28] costs, "tied" to the various forest supply regions of the world, based on a commodity

"extraction" [29] business. Fundamental business but very cyclical, very capital intensive, using known technology, with no great new opportunities for adding value, plant-based production economies of scale [30]

b) Based on your analysis summarise how "benign" or "adverse" you think the company's operating environment is, all things considered.

3.6 mins (2 marks)

Marking scheme - 1 mark for conclusion that the business is tough but not impossible, 1 mark for summary argument.

Tough – cyclical, very capital-intensive, potentially a low-volume, low-margin business, long asset investment cycle (20-year assets?), basic resource development in difficult parts of the world (politically, economically, financially, currency), commodity prices drive gross margin, significant plant-based overheads must be tightly controlled.

QUESTION 2 **23.4 mins (Total 13 marks)**

You have a full financial analysis based on the last audited accounts for 2009. You also have a summary of the results for the second and third quarters of 2010.

Required:

Summarise;

a) The company's track record, since its listing in 2007, in delivering bottom-line earnings from the assets employed.

9.0 mins (5 marks)

Marking scheme - I have 26 points so ¼ mark for each good point.

Sales flat, [1] gross margins declining slightly [2] and overheads stable, [3] exceptional items fluctuating [4] and reducing EBIT margins to a few per cent but recovery 2010. [5] Pre-tax return on capital employed around 10% or less [6] – barely enough. Return on EV less than the required 11 to 12%. [7] First half of 2010 looking better. [8]
2008 and 2009 affected by negative exceptional [9] items, 2008 severely (423 and 142) relating to acquisitions. So profit available for shareholders, after a slice for minorities [10] (a function of joint ventures around the world), was only Euro 98mill over 3.5 [11] years (0.45% on sales). After Euro 311 [12] of dividends a retained loss of Euro 213 [13] resulted.

Working capital now well [14] controlled at around 10% of sales (was 14% with higher debtors, lower creditors). Fixed capital intensity high around 50% (depreciable assets % sales), as expected, [15] but has risen with very high capex last few years (142 % of [16] depreciation). High effective rate of tax at 40%

average [17] but very volatile [18] and payments [19] actually reducing. Sales to assets turnover pretty stable overall but low around 0.95 capital intensity. [20]

High beta (1.33) and share-price variability [21] (51%), both rising i.e. high systemic and non-systemic risk.

Summary - Cyclical [22] and rather weak [23] financial performance in a high-risk business, with no marked improvements [24] in underlying performance before the current financial half year, and hard hit by the post de-merger, post asset acquisition and rationalisation costs. [25] PPP has it all to prove from here on in. [26]

b) The key features of the company's cash flows for the period 2007 to mid-2010.

7.2 mins (4 marks)

Marking scheme - I have 12 points so ¼ mark for each good point.

Cash flows – cash from operations was generally strong [1] - covers capex, tax (reducing), [2] and either interest or dividends [3] but not quite both, [4] although dividends were reduced [5] in 2009. But capex almost certainly above [6] replacement level in last few years, so not bad overall. Cash taxes are high at 50% of pre-tax profit. [7]
Initial share capital [8] plus initial cash balances [9] have paid for buying back old shares, [10] acquisitions, [11] debt reduction [12] and operating deficits. [13] Cash now mainly gone – need to start generating more and spending less. [14]
Volatility; Cash profits less volatile than operating profit, [15] but gradual trend downwards. [16] Non-cash and exceptional items very substantial and positive. [17]
Working capital pretty well controlled, [18] except 2010 first half, [19] when it resulted in an ICF deficit despite better profit. Capex now tailing off [20] after peaking in 2008. [21] Acquisitions have also tailed off for now. [22]

c) Its current credit strength bearing in mind your answers to Question 1.a., 1.b., 2.a., 2.b.

7.2 mins (4 marks)

Marking scheme - I have 20 points so ¼ mark for each good point.

Adverse sector [1] but PPP well positioned [2] strategically, globally large [3] and well diversified [4] re. geography and products.

Strong recovery indicated in 2010 [5] after severe effects of global recession/banking crisis 2008/9.

Leverage now 35% [6] on both market and book bases - a little high for [7] a cyclical, capital intensive challenging sector.

Interest Cover EBITA = 4.3 (just about (OK) [8] (was 5.2 then 2.7)
Interest Cover EBITDA = 7.6 (very good) [9] (was 9.0 then 6.1)

Net Debt / EBITDA now 2.0 (good) [10] (was 1.7 then 2.4)

- because size of depreciation relative to EBIT [11] (178 versus 231, half-year 2010)

But net debt/retained profit indicates 11.3 years [12] to repay (high) but it was as high as 29 years.

Return on capital is only just returning to almost acceptable [13] levels and has struggled to get above 10%. Will exceptionals continue [14] or are they finished?

Cash interest cover remains marginal, [15] given dividend payments, and very much subject to the level of capex and the continuing control of working capital.

This all seems to indicate a marginal [16] investment grade at best (BBB/BB).

QUESTION 3 **21.6 mins (Total 12 marks)**

Required:

a) Given your responses to Questions 1 and 2, identify four major finance/treasury risks, *other than currency,* facing PPP Group in the medium term, with a brief one-sentence justification for each risk identified.

7.2 mins (4 marks)

Marking scheme - 4 credible identified risks for a pass, adjusted for the quality of the justification.

Refinance: EUR 1.5 bn 2012 syndicated loan, given tighter bank capital adequacy/liquidity regulations and continuing financial market uncertainty

Sovereign Risk: emerging markets especially Russia

Interest risk: on debt and depos.

Counterparty risk: cash balances and mtm on derivatives, the latter a two-way item.

Treasury Structure: need to sensitise subsidiaries to treasury issues.

Geographic spread: impact on managing cash, liquidity and working capital of disruption to transaction flows

Financial structure: impact on cost and availability of refinance (and rating)

[Energy is not an issue as PPP, like most paper makers, is largely self sufficient as it recycles process heat to generate power]

b) What assumptions, quantified where possible, would you make about the extent of each risk in order to realistically stress test business plan forecasts? To what extent would you take correlation effects into account?

14.4 mins (8 marks)

Marking scheme - credibility of metrics for stressing each risk

Refinance	100 bp rate increase normal; plus only 67% availability abnormal
Sovereign	Emerging market countries remittances restrictions normal; Russia nationalisation with deferred compensation abnormal
Interest	100 bp; 250 bp; impact on net cost and collateral
C'party	All banks down one notch; two bank failures
Treasury	Inefficiencies due to poor MIS; major exposure escapes attention
Geographic spread	normal - cash increase of 10% (£7.7m), working capital increase of 5% (£33m); abnormal 25% (£19.3m), 20% (£130m)
Financial structure	similar in magnitude to "refinance" eg normal 100bp on rate; abnormal restricted availability, perhaps a commitment to use other of lending bank's services
Correlation	Under normal conditions correlation effects can be significant and therefore higher levels of individual risk may be tolerable. However under extreme stress everything can become correlated.

QUESTION 4 **21.6 mins (15 marks)**

You have a table with details of the forecast covenant situation for a Russian subsidiary of PPP which is now causing some concern. You also have a chart of the rouble/euro exchange rate over the relevant period (N.B. the dates have been changed for the purposes of this question).

This proved to be a very difficult question so the examiners have written long answer notes for the benefit of future students. We would not expect this amount of detail in an exam-time answer.

General Observations

The first thing to note about this situation is that the covenants refer to the performance of a subsidiary. Thus while the performance of the subsidiary contributes to overall credit metric performance, it is merely a subset of the group. To the extent that capital structure (and hence subsidiary credit metrics) is within the control of the group then one possible approach is that there is no problem with covenants in this subsidiary. In extremis the loan can be paid from central resources, thus cancelling the covenants. It is therefore crucial to understand why this loan might have been taken on and why it was drawn in euros.

It is possible that the export credit funding was subsidised, thus lowering the cost of finance. It is possible that the loan was taken on to reduce capital at risk in the Russian subsidiary, in which case the loan should have been non recourse to the PPP parent (or other non Russian subsidiaries). We are not told this but could reasonably assume this to be the case. If that is the case then it reasonable for the lender to have required subsidiary covenants, which are now forecast to be breached. It is also possible (but less likely) that the centre had insufficient facilities to fund the entire project.

It is not clear why the loan was drawn in euros but it is possible that drawings in roubles were not available from the export credit agency. It is also possible that drawings in euros fits in well with the overall cash flows of the subsidiary. While some product is destined for the local market, a significant amount will be exported, earning hard currency and probably euros. It would be useful to consider the consolidated group at this stage. It is likely that a risk averse treasurer might well choose a proportion of group debt in euros to match the cash flows. Thus while the policy of local currency funding has been breached, overall translation risk may have been sensibly approached.

The initial choice of debt / equity level is also a consideration; perhaps the tax rates are high in Russia, so that high debt there is justified. Inter-company debt on all other analyses is really equity.

In any case, out of EUR 350 million funding, only EUR 64 million remains in euro, or 18% of total debt (assuming that the inter company loan is fully hedged centrally). A drop in the rouble from 34 to 46 therefore increases debt in rouble terms as follows:

EUR 286 equiv	unchanged
EUR 64	X (46/34) = 86.5

Debt thus increases from EUR 350 equiv to EUR 372.5 equiv, or 6.4%. This is hardly terminal but risk does increase if hedging is not possible or the rouble continues to fall. However, it is also likely that paper selling prices could be increased to reflect the drop in the rouble, as such drops are essentially inflationary and indeed this has already hit 13%.

The next thing to notice is that the subsidiary, admittedly before the rouble drop and economic problems, is actually in a very strong situation and all credit metrics are improving. It is starting to look like the problem here stems from poor setting of initial covenant levels. A jump in levels from 1 to 3 in interest cover, 6 to 3 in debt / EBITDA and 1.7 to 0.9 are so extreme as to be almost ridiculous and point to seriously poor modelling. The covenant table is in euro which is quite surprising, but as borrowings are mostly in rouble, then total debt actually falls in euro terms, compensating for other bad effects.

So while a solution is probably easy, the benefits established would be lost and so it may be worth pursuing remedies.

It is hard to believe that other lenders of the export credit agency would not be in a similar position.

The following analysis is on the basis of pre crisis exchange and interest rates. Thus debt would fall significantly in euro terms although interest rates would increase. It will all be hard to model but frequent re-forecasting is necessary.

Required:

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

9.0 mins (5 marks)

Marking scheme - I have 30 points but this is a tough question so ⅓ mark for each good point.

The most serious [1] breach is in the EBIT Interest cover, from Q2 2012 to Q1 2013. [2]

In Q2 2012 EBIT is only 46% [3] of the required level, and 76% [4] by Q1 2013. At worst an EBIT deficit of 56.6mill [5]

EBIT is growing fast by [6] 2013 but maybe 15 months too late for the sharp step-up [7] in the covenant to 3.0.

At worst 18.9mill too much interest or excess debt of around 18.9 / 0.11 = 172mill, [8] (11.0% is the effective interest rate in Q2, 2012). The debt/EBITDA/covenant is only breached in Q2, 2012 [9] with debt 19% or 51mill, [10] too high or EBITDA shortfall of 17.1mill.

This suggests that the levels of the two covenants are not consistently aligned, [11] as well as reflecting the varying but large differences between EBIT and EBITDA. [12]

TNW shortfall is 38mill max and covers only two quarters, the [13] easiest to fix.
The Debt/TNW breach covers Q2 & Q3, 2012, with debt 13% and 7% too high respectively, ie 38 to 19 [14] of excess debt. Of course, swapping equity for debt would require only 38/2 new equity = 19mill. [15]

An obvious solution is to convert some of the inter-company loan [16] to equity capital - 52 [17] million sorts out the second and the third covenants, 112 million [18] would also sort out all but the Q2 2012 interest cover, which the banks might accept. The parent could reduce the interest rate [19] on the loan to fix that. But the parent may not want permanent reduction in debt/increase in equity. The parent could also subordinate the inter-company debt, [20] if not already done at the outset. This has the effect of increasing net worth. The interest could also be rolled up and excluded from covenant definitions. [21]

Then look for possible improvements in EBIT [22] or reduction in interest paid – simulate different fx, inflation and interest-rate [23] scenarios for the next 2 years, look at internal [24] transfer prices into E. Europe and Israel, also group [25] overhead charges into Russia, investigate short-term cost cutting [26] and cash-saving [27] exercises. This seems a high operational price to pay for poor initial financing arrangements.

Then explore re-negotiation [28] of covenants, especially the sharp step-up in Q2 2012, [29] which was obviously premised on reaching a significant stage in the profitability of the project which has not been achieved yet because of the delays.

It is also possible to re-set [30] covenants on the basis of group performance, rather than Russian performance. In that case, however, the loan might have to be made with recourse (guarantee from) the parent, which might not be desirable.

Required:

b) What impact is the current currency problem likely to have on the various covenants and how might this affect your proposed solutions in question 4a?

9.0 mins (5 marks)

Marking scheme - I have 26 points but this is a difficult, complex question so ⅓ mark for each good point. In the end I was just looking for some clear thinking and some logical analysis for awarding marks.

The biggest issue here is that the covenant table is set [1] in Euros, which seems completely inappropriate and was obviously based round the export credit agency loan which was made in Euros. This should ideally be changed as it distorts the picture and does not reflect the management of the business, which is run in roubles. [2]

Interest on the 64m [3] EUR unhedged export credit facility will cost more [4] in rouble terms with the devaluation of the rouble (about 28% [5] currently, so interest rate say 3.8% instead of [6] 3%).

But bank covenant table is in EUR so interest stays same and (rouble-based) EBIT, EBITDA will reduce [7] having some adverse effect on covenants, [8] assuming no non-rouble [9] element in EBIT, EBITDA. Debt falls in EUR terms because the debt is mostly drawn in or hedged back to euros. [10] Covenants are hopefully defined so that derivatives are included in debt, allowing the reduction to cover the hedged element of the export credit debt.

The 26m [11] hedged facility will maintain EUR value, increase in rouble terms, along with TNW so gearing [12] aspect not hedged. Rouble interest will increase [13] dramatically (up to 22%, but the increase is offset by than the amount of the rouble devaluation [14] to date, so interest will probably increase in Euro terms[15]. (The interest rate has increased from 6% to 10% or more. That is a minimum increase of 66% so interest will probably go up in euro terms as 66% is more than the 21% fall in debt in euro terms).

The interest cost of the 350m inter-company [16] loan, being financed via short-term swaps during the (delayed) construction period, has gone from 10% to 30/55%, [17] but is this to be passed on to the Russian subsidiary? [18] The Euro equivalent interest rate is 28/43% [19] instead of the original 10%, so a serious [20] impact on the interest cover covenant. The balance sheet is hedged.

The key question is how long will the [21] crisis last - will it be over before the actual covenant period in 15 months' [22] times and, if so, what will be the residual [23] impact on debt (therefore interest) and TNW?

If the situation persists the unhedged element represents a big problem [24] and it would have to be re-financed. In any case the swap-financed inter-company loan is the biggest problem [25] especially as the swap market could close. Needs to be refinanced, an equity swap being the safest solution. [26]

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

7.2 mins (5 marks)

Marking scheme - ½ mark for each good point.

Obviously cross-default clause [1] implications, with all the associated costs and dangers, [2] especially as PPP is seeking an investment grade [3] rating.

Also reputation [4] risk with banks and markets generally. Re-pricing risk, especially recently. [5]

How avoided? - for complex current situation avoid P&L [6] plus B/S covenants. Somehow allow for project slippage [7] re. step-up covenants. Avoid tricky [8] short-term financing where currency likely to be under threat or market not very robust. Reference financing methods to economic/currency [9] forecasting. Precise covenant definition [10] is critical (B/S [11] versus P/L effects, accounting treatment etc).
Hedging policy should have been observed. [15] Isolate external debt from inter-company debt in covenants. [12] Stress test covenants against project performance scenarios. [13] Avoid 100% debt finance on high risk projects. [14]

QUESTION 5 — 23.4 mins (Total 13 marks)

Required:

a) **Review the main company valuation methods, both DCF-based and multiples-based and in each case discuss the practical difficulties involved in valuing a company such as PPP. You should illustrate your discussion with examples based on the various information sets provided.**

18.0 mins (10 marks)

Marking scheme - I have 43 points so ⅓ mark for each good point.

P/E valuation [1] – an equity valuation method, [2] which presumes that the level of gearing remains fairly stable. PPP and others in the sector have suffered negative [3] earnings, so an assessment of normalised [4] earnings is more important than ever. In addition the likely sustainable growth [5] rate in a mature, difficult sector is hard to assess, and PPP has not really established a stable [6] post-float growth and earnings track record. Are the rationalisation exceptional costs now finished? [7] Are there new synergies or economies of scale, [8] extra profits growth from the last few years' high capex? PPP historically shows a P/E range from n.a. to 14.8. [9] The P/E of 62.1 indicates abnormally low earnings - not a reliable guide! Peers 4.5 to 13.5 [10]

EV/EBITDA [11] – an entity [12] valuation method, which is arguably more reliably based on fundamental cash profits and much less likely [13] to be affected by negative results (i.e. at EBITDA level as opposed to Earnings level). In such a capital-intensive business depreciation will be [14] significant in relation to EBIT so lower multiple swill be required than for other sectors e.g. 5 to 6 EV/EBITDA(for PPP historically depreciation was 133% of EBIT, 46% of EBITDA. Range for PPP is quite narrow (4.96 to 6.12) [15] For peers 6.2 to 7.7 - looks quite stable [16]

EV/Sales [17] is a more stable metric [18] useful when profits are under abnormal pressure. PPP average 0.61 to 0.85, [19] peers 0.81 to 4.70. But the value depends on profit margins achieved on sales so will vary. [20]

EV/Invested Capital [21] (or Assets) also pretty stable [22] but dependent also on level of profitability on assets employed [23] - peer group range 0.84 to 1.20. [24]

DCF method 1 [25] - multi-period DCF requires reliable and informed [26] cash flow projections for several years, which are only [27] available to company and sector specialists. A company WACC must be calculated (OK) plus the long-term sustainable cash flow and growth rate [28], as for DCF method 2 below, which is tricky.

DCF method 2 [29] – capitalising sustainable cash flow [30] using calculated company WACC [31] and estimated sustainable growth rate. [32] Probably a more robust method if one has the appropriate cash flow analysis [33] skills, as well as good profit forecasts (as above). Big cash flow issues for PPP are sustainable capex [34] levels and company's ability to maintain its working capital [35] achievements, so containing the potential cash drain to working capital. From the evidence of the last few years estimates of sustainable post-tax entity cash flow vary from 171 to 269, [36] average about 200. Dividing by a real WACC of about 5.5% less a low sustainable real growth rate (-1.9% [37] to 3.1%) gives the recent market values for PPP's EV. Range for PPP is 14.4 to 36.0 [38] for EV/SCF.

b) Given your answer to question 5a, what are the implications for PPP company management now that their current priority, after the listing and the subsequent strategic re-structuring, is to focus on delivering returns to shareholders.

5.4 mins (3 marks)

Marking scheme - ⅓ mark for each good point.

Establishing a stable [1] track record of predictable sales and profit [2] levels, ideally growing, [3] despite the cyclical [4] nature of the industry. Even more important delivering predictable [5] earning and at a higher level [6] than to date, through cost savings and efficiencies [7] in this fixed cost-heavy industry, and demonstrably lower tax [8] management. Need to show that the big exceptional items are now finished [9] with. Also improving the cash conversion [10] ratio with a maintained focus on working [11] capital and lower capex [12] for a few years until resuming at "as low a level as possible the capex necessary to maintain the business". Need to ensure that future acquisitions [13] and capital projects [14] pay off financially as well as strategically, [15] and demonstrably so.

Above all the company needs to talk shareholder [16] value and embed it as a discipline. [17] It needs to inform the market more about its plans [18] and to deliver on its promises [19] – to build up the valuations relative to underlying performance i.e. to earn higher multiples. [20]

QUESTION 6 **32.4 mins (Total 18 marks)**

Required:

a) Explain briefly how the various types of currency risk arise in PPP Group.

9.0 mins (5 marks)

Marking scheme - mention of transaction, translation, contingent and economic risks adjusted for quality of explanation.

FX (transaction)	9 functional currency zones, paper is USD commodity eg $ imports, local fx costs/revenues, $ exports
FX (translation)	101 production sites in 31 countries
FX (tender to contract)	5 major sites - S.Af, Russia, Poland, Slovakia, Austria
FX (economic)	imports/exports in competition with suppliers with different cost basis, currency

A PPP subsidiary wishes to hedge ahead one calendar year imports in EUR of paper from a fellow PPP subsidiary which it converts into bags and sells on in USD to repeat-order customers.

Hitherto hedging has been executed periodically during the year as orders are placed by the subsidiary with the in-house paper supplier.

b) Comment on the pros and cons of this policy.

12.6 mins (7 marks)

Marking scheme - for a pass, looking for a total of about eight points capturing the pros and cons of the proposal, particularly the interplay of intra-group risk between the subsidiary and its paper supplier, the way the subsidiary conducts contract negotiations with its customers and the local competitive background.

- Better if hedges are only concluded once the contract is agreed, otherwise there is a risk of having to close out contracts if the sales negotiations fail.

- The downside to this new approach is that if sales reduce, hedges will have to be closed out which may lead to losses (or possibly gains).

- Need to be satisfied that have not written options for customers. For example, if competitors do not fix their exposure, will customers reduce purchases from us and move their business to the competition because of better pricing from lower exchange rates?

- Need to be sure that the business unit is satisfied that incentives to local management have not been reduced by a change in policy. The current policy requires tough negotiations, i.e. to build in a "buffer" on the exchange rate to allow for the exchange rate to move against the entities. Will the incentive to negotiate hard be reduced if the FX risks are reduced?

- Is hedging 80% of sales too high? The business unit will have a better feel than me for the appropriate percentage.

- If the policy is to change, probably better if the hedging is done by the PPP entity <u>selling</u> the paper. That entity should quote a fixed USD price for 1 year and Treasury can hedge the exposure. The reason for this is that there might not be sufficient expertise in the paper purchasing region for such hedging.

- One argument against a change in policy is that the region has managed the FX issue successfully in the past and therefore is the issue as significant as is suggested.

c) What would you recommend?

3.6 mins (2 marks)

Marking scheme - continuing "as is" or accepting the proposal are both viable, as long as the different risks associated with each course of action, especially the new proposal, are well understood. So the answer should show evidence of this understanding.

The only certain way for the subsidiary to remove its risk is to use options to hedge the fixed price agreed for the coming calendar year and build the price of the options into the fixed contract price. The subsidiary also needs to agree a fixed call-off volume with its customer, along with penalties to cover the cost of over-hedging if the call-off is not fully taken up.

Under the historic arrangements the subsidiary has approximated this behaviour by building a margin for currency volatility into the fixed price and persuading the customer not to exercise its option to go to a cheaper supplier when rates move in favour of local competitors.

In the past the arrangement seems to have been managed successfully by the subsidiary, which is an argument for the status quo. If the proposal to change is accepted then the following could be a suitable way to proceed.

- 70% one calendar year ahead after contract
- try for "exclusive supplier" status
- hedge at paper supplier end
- monitor competition behaviour
- review sales trends quarterly to pre-empt emergence of overhedge
- bear in mind the need to keep pressure on contract negotiations via KPIs.

d) Identify key parameters for the management of currency translation risk in PPP Group.

7.2 mins (4 marks)

Marking scheme - expect reference to balance sheet and profit/loss impact, eg on gearing and on interest cover covenants, and to shareholder expectations.

- significance of net investment in each currency
- impact on interest
- impact on net worth
- investor preferences

QUESTION 7 **14.4 mins (8 marks)**

PPP has a EUR 1.5bn Guaranteed Euro Medium Term Note Programme in place, providing a potentially flexible basis for refinancing maturing debt. It is Q4 2010.

Required:

a) Given continuing uncertainty about future economic conditions, what factors would you take into account regarding the refinancing process?

14.4 mins (8 marks)

Marking scheme - expect reference to external financial market conditions, PPP future performance trends, source of funds, maturity of funds and instrument features.

EMTN provides flexibility of source and features, current syndicated loan is 'all or nothing'

- **Source**
  - Diversify sources
  - If non-functional currency be aware of collateral exposure on currency swaps
  - Seek counterparties with substance which can maintain the relationship through downturns.
- **Maturity**
  - Diversify maturities to avoid concentration.
  - Seek drawdown and repayment flexibility
  - In aggregate avoid future maturity concentrations
- **Features**
  - Seek to retain uniform documentation
  - Build in flexibility where possible eg basis,
  - Keep some bank debt for flexibility
  - Resist structures which eg involve selling options to investors

- **Context : Status of PPP and External World**
  - PPP business and financial performance trends
  - Consequent rating status and outlook
  - Views on bank recovery from financial crisis and consequent cost/availability of funds
  - Views on interest rates 2010 - 2012

- **Timing**
  - Secure funding ahead of time if practicable subject to assessment of rate and availability prospects
  - Manage relationships with existing syndicate members / other counterparties so that in aggregate the refinancing strengthens the firm's circle of financial counterparties

QUESTION 8 21.60 mins (Total 12 marks)

Marking scheme - (8a, 8b) - credibility of the "current" and "future" profiles taken together and the quality of the narrative in 8.b.

Required:

a) On the Treasury Organisation Matrix Pro-Forma provided create a profile for the current PPP treasury by ticking the cell in the top left hand corner of the appropriate box.

3.6 mins (2 marks)

- ROLE: agency
- AUTHORITY centralised
- RESPONSE TO RISK cost centre
- ORGANISATION intermediate

b) **Given what you have read about PPP in the case study and the views you have formed about the business while thinking through your answers to earlier questions, what profile would you wish to adopt for the medium term? Justify your choice.**

7.2 mins (4 marks)

- ROLE — -in-house bank
  -scale justifies, also desire to control and improve performance

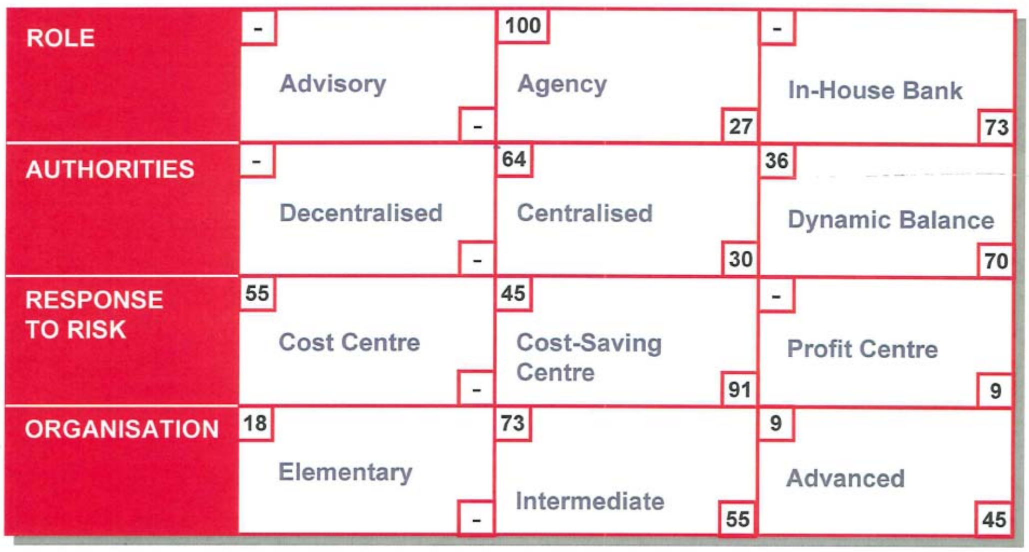
- AUTHORITY — -dynamic balance
  -to increase awareness of treasury dimension

- RESPONSE TO RISK — -cost saving
  -scale justifies the effort, fits with Pillar 3 of corporate strategy

- ORGANISATION — -advanced
  -consistent with shift in the other three dimensions

The responses of candidates regarding current and future profiles are summarised below. In aggregate they respond closely to those suggested above.

Treasury Organisation Profile: Responses %



c) How would you organise the functional and geographic structure of treasury? For example what authorities would you retain at the centre and what would you delegate to Divisions and individual subsidiaries, JVs?

10.8 mins (6 marks)

Marking scheme - demonstrated relevance to PPP, credibility of total structure proposed, quality of narrative and detail.

- Presumption in favour of centralising funding, fx and interest risk management for economies of scale, showing one face to markets and leveraging on expertise at the centre.

- Regional cash pooling.

- For rating purposes, if PPP wishes to escape the South African sovereign cap on its rating it needs to fund ex UK.

- However, there is a need to make the businesses more aware of the impact of business decisions on treasury/finance . . . . ref. Question 6b . . . . so more subsidiary involvement should be structured in.

There was a very wide spread in quality of response to 8.c., from 85% to 25%, with several candidates submitting half a page with a basic generic structure un-related to PPP.

EXAMINER'S REPORT - CASE STUDY EXAMINATION

QUESTION 1

This was a variation on the “usual non-financial analysis question”, which was very well and thoughtfully answered. In earlier exam sittings many candidates have been tempted simply to “dump” a pre-prepared SWOT, STEP or Porter analysis without regard to the focus and particular wording of the question set. This was generally not the case this time around. The required focus was on delivering shareholder value given the company’s recent history and current strategic focus, and most candidates built their answers around this theme.

QUESTION 2

This was a variation on the “usual financial analysis question”, which was surprisingly and disappointingly, rather poorly answered. The first part of the question asked for an analysis of the company’s track record in delivering bottom-line earnings form the asset base, the second asked for a summary of the salient features of the last three years’ cash flows, and the third asked for an assessment of the current credit rating.

The core ratio analysis of earnings performance was the weakest (average 44.5%, passes 4) and the credit rating assessment the strongest (average 56.8%, passes 8), with cash flow analysis reasonable in the middle (52.3%, passes 7). Recent examinations have also revealed stronger understanding of the credit rating issues than the shareholder issues – a sign of the times maybe?

QUESTION 3

A two part question, part (a) asking candidates to identify four major finance/treasury risks (other than currency) and part (b) asking for assumptions about quantified stress test limits for each risk mentioned. Part (a), something of an evergreen question was comprehensively answered, part (b) less so . . . demonstrating again candidates lower appetite for quants.

QUESTION 4

This was a tough but very practical, realistic question on subsidiary company covenants in a setting of extreme currency and interest rate volatility, coupled with 100% debt finance, partly unhedged and dependent on the short-term swaps market. It was perhaps the most relevant, practical question for future potential treasurers. However, most candidates were comprehensively defeated by the requirement for clear, conceptual thinking combined with correct manipulation of the numbers.

The first part asked for a quantitative evaluation of the scale of the covenant problem, largely caused by serious delays in the implementation of a huge capital project, and review of possible solutions (50.9%, 6 passes). The second part (18.2%, no passes) asked for an evaluation of the impact of the local currency / interest rate / inflation crisis on the already problematical covenants. Rather worryingly candidates seemed unable to apply standard stuff on currency transaction and translation risk to make sense of this question. The third part (average mark 48.2%, 7 passes) was a more general question on the importance and methodology for managing covenants within a global group of companies.

QUESTION 5

This was a demanding question on the practical difficulties of applying the different valuation methods to a pulp and paper company like PPP and its sector peers. The question required a review of the core methodology of the main valuation methods. But, in addition, the question specifically asked candidates selectively to use the detailed valuation data given in the question and in the case study background material to illustrate the issues e.g. the volatility over time and across companies of virtually all the multiples given, or the volatility in profits and cash flows in PPP over the last few years, which made an assessment of sustainable performance in a long-cycle business very difficult. Very few candidates actually complied with this requirement, none thoroughly. The 3-mark supplementary question about the consequent priorities for management seemed to defeat all candidates.

The question did not ask for a valuation of PPP but several candidates attempted one.

QUESTION 6

Part (a) asked candidates to explain how the various types of currency risk to which PPP Group is exposed arise. This was a straight-forward and simple test of basics which was generally answered very well, although half missed out either contingent risk (list price/tender to contract) or economic/strategic risk. Parts (b) and (c) were about an overseas subsidiary which buys paper in EUR from a fellow PPP subsidiary, converts to bags and sells in USD to a pool of repeat-order customers in competition with local suppliers who also sell in USD. The subsidiary contracts annually a fixed price with its repeat-order customers but transacts hedges periodically throughout the year as orders are placed. To compensate for the hedge mismatch the subsidiary negotiates some slack into the fixed price but risks losing the customer if competitor prices fall because the contract is not binding in this respect. The subsidiary now wishes to hedge forward a full year when “contracts” are negotiated, but this then creates the risk of over-hedging. This is a classic fx dilemma combining issues about competitor behaviour and where best to carry the risk within the international corporate structure - a discriminating test with a wide range of scores. Part (d) was about factors which should be considered when deciding on how to manage PPP’s translation risk. Despite the pervasiveness of currency risk in most corporate treasuries, the average overall mark for this question was below 50% (the pass mark).

QUESTION 7

PPP Group is facing a major refinance of syndicated bank debt before end 2012 and has an EMTN in place already. Candidates are asked to indicate the factors they would take into account regarding the refinancing process, given the uncertain current (Q4, 2010) economic conditions. In aggregate candidates covered the ground well. However at the individual level some responses were noticeably partial: main gaps in the discussion were maturity spread, source diversity, timing in anticipation of financial market conditions, acceptable covenants.

QUESTION 8

Three-part largely evergreen question about profiling PPP's treasury organisation now, speculating how it might develop in the future and proposing a functional/geographic structure to accommodate the change. Overall a well-answered question, with unsurprisingly the biggest spread of marks on the third part.