The Association of Corporate Treasurers

Examination Paper, Solutions and Examiner's report

Paper: MCT General Exam

APRIL 2011

Answer **ALL EIGHT COMPULSORY** questions

QUESTION 1

To follow is a chronological description of the demise of housing construction and maintenance group, HCMG plc, plus summary financials on page 3.

2000-2007
HCMG was transformed by Chief Executive Henry Hodge, from an ailing local builder in 2000 into a "darling of the stock market" valued at £436 million in mid-2007. He achieved this largely by acquisition of other regional building firms throughout the UK. By the end of 2007, however, the value had fallen sharply to £190 million, very much in line with the building sector generally, on fears about the impending recession and banking crisis.

2008-2009
In late-2008, despite a Directors' upbeat commentary a few months' earlier, the company issued an unexpected profit warning as clients hit by the Icelandic banking crisis stalled 50 of its projects. The share-price halved on the news. Directors explained that this set-back was a one-off, announcing redundancies and a shift away from construction into higher-value repairs, and delivered much-improved profits to December 2009. Market capitalisation finished the year at £79 million.

2010
In May 2010 the company issued another profit warning, following unusually icy weather in January and February which created a back-log of work, reduced house-building activity and problems in its newly-acquired plumbing division, which the company insisted had now been resolved.

In August the company announced a third profit warning: a PwC investigation, commissioned by the Chief Executive, had discovered "serious failings in financial controls" at the plumbing division acquired three years' earlier and the Finance Director was suspended. In the same week the Interim Results showed underlying profits halved at £3 million compared with the previous year, but after re-structuring costs of £6-8 million in the troubled division EBIT showed a loss of £3million. The dividend was cut by one third. The company remained "cautiously optimistic", despite the threat of Government cut-backs on its social housing work and despite the fact that a rival construction company went into administration. The Chief Executive insisted that HCMG was different and bought more shares in the company. However the market capitalisation fell to £29million on the news. The Finance Director was later cleared of any wrong-doing but quit and a specialist Chief Financial Officer was appointed in his place to re-assure the markets.

However, following these events suppliers and customers began to lose confidence fast. Analysts were also concerned that the company relied unduly on direct employment rather than subcontracting labour like most of the industry.

The company was also in the middle of re-financing talks but had insisted that it had sufficient head-room in its existing £81 million banking facilities. Its bank loans were drawn under a revolving credit facility which was due to expire in 2012. However, poor trading and cash-flow pressures indicated a likely covenant breach by Christmas 2010 and the need for an extra £20 million of facilities. In early November, the banks refused and HCMG went into administration.

Required:

a) **This has been described as a classic case of poor financial management. From the description of HMCG's demise what would you say were the main failings in the financial management of the company, considering all aspects of "financial management" through from financial strategy to financial control, and embracing both creditor and shareholder dimensions, as appropriate?**

(8 marks)

b) **Based on your answer to question a), the descriptive material and the summarised financials, do you think that the failure of the company was inevitable? Give your reasoning and evaluate as far as you can the effect of external factors versus factors within management's control.**

(7 marks)

(Total 15 marks)

Housing Construction & Maintenance Group (HCMG)

PROFIT & LOSS

£ mill	2006	2007	2008	2009	2010
Number of months	**12**	**12**	**12**	**12**	**6**
Sales Revenue	**689**	**948**	**1,011**	**715**	**308**
Gross Profit	**75**	**103**	**95**	**81**	**35**
Gross Marfgin	10.8%	10.8%	9.4%	11.3%	11.2%
EBIT	**22**	**30**	**7**	**18**	**(3)**
EBIT Margin	3.2%	3.2%	0.7%	2.5%	(0.8%)
(Interest Paid)	(2)	(2)	(1)	(1)	(1)
Profit before Tax	**20**	**28**	**6**	**17**	**(4)**
(Tax)	(6)	(9)	(2)	(4)	1
Extraordinary Items			(19)	(5)	(1)
(Ordinary Dividends)	(4)	(5)	(6)	(4)	(3)
Retained Profit for Year	**11**	**15**	**(21)**	**5**	**(7)**

CASH FLOW SUMMARY

Operating Profit	24	32	7	19	(2)
Other Non-cash & Exceptional Items	(1)	1	9	(8)	2
"Cash Profit"	**23**	**33**	**16**	**12**	**(0)**
(Increase) / Decrease in Net Working Assets	15	(4)	(26)	(20)	(1)
Tangible Asset Depreciation	3	5	7	6	2
Net Capital Expenditure	(4)	(9)	(5)	(2)	(1)
(Tax Paid	(5)	(5)	(3)	(0)	1
(Dividends Paid)	(3)	(5)	(6)	(4)	(3)
Cash Flow before Interest	**28**	**16**	**(18)**	**(9)**	**(2)**
(Net Interest Paid)	(1)	(1)	(1)	(1)	(1)
Internal Cash Flow	**27**	**15**	**(19)**	**(9)**	**(3)**
ACQUISITION & FINANCING CASH FLOWS					
(Acquisitions),Disposals,(Investments)	5	(30)	(20)		1
Increase / (Decrease) in Net Debt	(32)	15	39	9	2
Net Financing Cash Flow	**(27)**	**(15)**	**19**	**9**	**3**

BALANCE SHEET

Intangible Fixed Assets	83	125	148	146	146
Property, Plant & Equipment	16	21	20	17	14
Financial Investments	13	12	9	8	9
Total Fixed Assets	**111**	**158**	**176**	**172**	**170**
Stocks	52	42	13	8	13
Trade Receivables etc	165	224	201	183	180
Cash etc	44	43	39	6	13
Other Current Assets			23	15	14
Total Current Assets	**261**	**310**	**276**	**212**	**221**
Total Assets	**373**	**468**	**452**	**383**	**390**
Total Debt	33	48	83	52	61
Trade Payables etc	215	277	247	202	206
Provisions & Other liabilities	25	18	18	23	29
Total Liabilities	**273**	**343**	**347**	**278**	**296**
Total Shareholders' Funds	**100**	**125**	**105**	**106**	**94**

SHARE PRICES

Average number of common shares	149.7	171.4	175.4	175.7	175.5
Common Share Price - Low (pounds or equivalent)	0.95	1.00	0.20	0.30	0.27
Common Share Price - High (pounds or equivalent)	1.55	2.50	1.35	0.52	0.49
Common Share Price - Average	1.25	1.75	0.78	0.41	0.38
Market Capitalisation - Common Stock	187	300	136	72	67
Net Debt	(12)	5	44	47	48
Enterprise value [EV]	**176**	**305**	**180**	**119**	**114**

QUESTION 2

A recent article on private equity indicated that for a sector with systemic risk 25% above average PE, investors could now expect a lower IRR return compared with the expected figure pre-banking crisis. This is based on a current 30% debt component instead of the earlier 30% equity, debt interest rates of 12% now rather than 8%, and an non-quoted additional equity premium of 3% as against the earlier 2% (PE firms typically add this additional equity premium on top of the quoted-company CAPM formulation). It is assumed that the risk-free rate of 4.5%, a market risk premium of 5.0% and a tax rate of 28% remain unchanged. The holding period to PE exit is now expected to be typically five years as against the former 3 years.

Required:

a) **Calculate the required equity returns and the WACC under each of the two scenarios. Comment on the different figures for the required equity returns and WACCs.**

(5 marks)

b) **Calculate the annual EV growth rate required under the two scenarios to deliver the respective compound rates of return to private equity investors. Assume that 10% of the debt could be repaid annually out of cash flows under the earlier regime and 20% under the new regime. Summarise the risk/return implications for PE investors of the changes.**

(6 marks)

(Total 11 marks)

QUESTION 3

A recent article in *The Treasurer* highlighted the recent revival of the corporate capital market for debt-equity hybrids, due to “low swap rates, the absence of bank issuers, greater transparency of Moody’s revised methodology and reduced structural complexity”.

Required:

a) **What are hybrids? Summarise the characteristic features of hybrids.**

(3 marks)

b) **Summarise the advantages to the corporate issuer of hybrid capital market instruments. Who would be likely to make use of them?**

(3 marks)

c) **Summarise the advantages and disadvantages of hybrids for investors.**

(2 marks)

(Total 8 marks)

QUESTION 4

Required:

a) What are the relevant considerations in deciding a company's dividend policy, both practical and theoretical? Support your answer with illustrations of the metrics used to decide the appropriateness of dividend policy, together with numerical examples.

(6 marks)

b) What are the most important considerations, from the shareholder's point of view, when evaluating a company's dividend policy? Again, use numerical examples of shareholder metrics to illustrate your answer.

(4 marks)

c) How does the market react to a reduction in dividends, which have been quite common since 2008?

(3 marks)

(Total 13 marks)

QUESTION 5

K-Jet entrepreneur Sir Mikael Klein recently arranged a one-year loan with Investment Bank IBG by providing 1,267,000 K-Jet shares as collateral. Sir Mikael retains voting and dividend rights. This sum, together with £13m raised from other sources, is being used to finance the purchase of a London property for his K-Hotel chain.

The expectation of both parties is that the loan will be repaid. However as a hedge, Sir Mikael has put in place a collar option with IBG under which he has bought the right to sell shares to IBG at 362p and sold IBG the right to buy shares from him at 577p when the loan matures. Share price at date of deal was 402p.

The value of the transaction is £5.1m (number of shares by current share price).

The amount lent by IBG is £5.1m discounted by a factor taking into account prevailing interest rates, credit spreads and the term.

Required:

a) What are the attractions and drawbacks of this arrangement for Sir Mikael?

(7 marks)

b) What are the attractions and drawbacks of the deal for IBG?

(5 marks)

(Total 12 marks)

QUESTION 6

You have been appointed Treasurer of Saturn Housing Association (Saturn). Your background is corporate and you see this new role as a challenging opportunity to apply core treasury principles in a quasi-public sector entity which is having to be more commercial to survive in the current post crisis environment.

Housing Associations (HAs) are ‘not for profit’ charitable organisations tightly regulated as to financial viability and customer care. They receive Government grants, which together with money raised from banks and capital markets they use to build houses and flats with ‘affordable’ (ie capital grant subsidised) rents, often let to families or individuals receiving social benefit. Rents have been strictly controlled and tenancies are for life. Typically debt has been secured 30/35 years, with the majority swapped to fixed rate until maturity and with very low interest rate cover ratios of, say, 1.10 reflecting the traditional predictability of income and expenditure.

There are 1700 HAs in the UK, owning 2.3m residential units. Half of the units are owned by 53 HAs, with portfolios over 10,000 units. Historically HAs invest in long term projects with largely fixed revenues and costs and do not pay tax or dividends. Those which access capital markets direct, circa fifteen, are rated Aa2 to A1, underpinned by assumed Government support. Some of the larger HAs originated from the transfer of Local Authority council housing stock (effectively a privatisation).

Saturn is the result of such a transfer in the 1990’s, is not rated and has earned a reputation for developing new sites on time, within cost and to a high build standard - its Development Division punches above its weight in this area. Saturn has bank debt facilities of £600m (drawn £500m), total assets of £800m and revenue of £60m.

Potential new build projects are identified by the Development Division, evaluated against funding parameters approved by the Board and bid for within the context of available Government grant. Projects above a certain size are subject to an Internal Viability Review (IVR) by Treasury; passed to the Financial Resources Sub-Committee (FRS is the financial/treasury sub-committee of the main Board, and a companion to the Audit and Remuneration sub-committees) which passes them on to the main Board with its recommendations.

Required:

a) Draft a template for appraising new development projects covering the key areas of analysis, evaluation and governance (governance meaning approval and control of new development projects).

(9 marks)

In the current spirit of severe cutbacks the Government has virtually abolished grant over the next four years and is also reducing social benefit. However there is still a massive undersupply of affordable housing. So the Government has compensated for loss of grant and benefit by relaxing rent control and allowed the provision of affordable housing with a wide range of intermediate tenures going down to as low as five years, as well as stripping the regulator of most of its powers and merging what remains with the grant funding body, amounting in all to a significant deregulation.

The current Chairman has a building sector background and since his appointment two years ago has restructured the Board to give it a strategic rather than operational focus and to encourage a more challenging relationship between executive and non-executive members. Of the three executive directors both the Operations and the Financial Director have been replaced and only the Development Director remains. The most recent appointment to the Board is the retired Managing Director of a national housebuilder.

Saturn's strategic response to the disappearance of grant is to exploit the opportunities which deregulation has provided. The intention is to utilise the proven track record of the Development Division to tap into the vast amount of unsatisfied demand for affordable housing across intermediate tenures between traditional social housing and private housing, eg by offering tenures as low as two years which are not grant supported to low income entrants to the job market who do not qualify for social housing but cannot afford a mortgage. A new subsidiary Devco, to be chaired by the retired Managing Director, is being established to execute this type of non-grant assisted, for-profit activity which will donate its profits made to the parent to subsidise social housing in place of grant.

To support this strategic shift and to double in size by 2018, a culture change programme is in progress to instil innovative and entrepreneurial values within Saturn's executive and management.

Required:

b) What are the risks associated with these new developments?

(4 marks)

(Total 13 marks)

QUESTION 7

You are Treasurer of a company which is a recent management buy-out (MBO) and which includes private equity investors seeking an exit in 5 -7 years. Debt is high and there is a very strong focus on generating cash at the centre and paying down debt in line with progressive covenants.

The business provides high accuracy liquid flow control valves for high pressure, high temperature applications in the food and pharmaceutical process industries where hygiene, accuracy and reliability are paramount. The technology underpinning the product, which has some unique features, was developed for rocket-based defence products. The process industry applications emerged by chance and did not sit comfortably in a large defence manufacturer, hence the MBO.

To date, all sales, manufacturing and components have been UK based/resourced. Turnover at £8m represents less than 1% of the global market which is growing at 8 -12% p.a. The company's strategy is to expand overseas, initially by exporting then subsequently by joint venture/licensing/partnering, and to dramatically improve competitiveness and operational flexibility by aggressive supply chain management, establishing a high earnings growth record prior to a trade sale or IPO in 5 -7 years.

The CEO has asked you to set up and lead a supply chain project management team. The remit is to resource components from the most cost effective and flexible sources worldwide and to transition the manufacturing function to assembly and quality control.

Required:

a) What business functions would you need to recruit to the project team?

(4 marks)

b) What particular contribution would you expect each to make?

(8 marks)

c) What are the treasury implications of the supply chain remit?

(6 marks)

(Total 18 marks)

QUESTION 8

Reproduced below are two quotes from an article about Ethics, Enterprise and Expediency:

- "customers prefer to buy from companies exhibiting *good corporate citizenship*"

- "businesses can forestall regulation by behaving with conspicuous virtue, thereby keeping a lid on costs"

Required:

a) Is there a business case for adopting a policy of high ethical standards and corporate social responsibility, externally in relation to customers and/or internally in relation to staff?

(5 marks)

You are Treasurer of a medium sized publicly quoted UK manufacturer which has been going through a difficult patch due to the recession and which is currently working near the limits of its banking facilities. Along with your Finance Director, you are just about to meet with your main bankers for the quarterly review when you learn from the Sales Director that two of your major customers, representing 30% of turnover, have radically reduced their order levels for the next quarter. Unless this sales volume is replaced, the company is likely to exceed its bank facilities. There is no time to check out the full truth of the Sales Director's news. You are in favour of disclosing this possibility to your bankers, but the Finance Director forbids it.

b) What do you do and why?

(5 marks)

(Total 10 marks)

GENERAL EXAMINATION - NOTE FORM ANSWERS

QUESTION 1 **27 mins (Total 15 marks)**

You have a chronological description of the demise of housing construction and maintenance group, HCMG plc, plus summary financials.

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Required:

a) **This has been described as a classic case of poor financial management. From the description of HMCG's demise what would you say were the main failings in the financial management of the company, considering all aspects of "financial management" through from financial strategy to financial control, and embracing both creditor and shareholder dimensions, as appropriate?**

14.4 mins (8 marks)

Marking scheme - ⅓ mark for each good point.

Rapid growth built on acquisitions is always a risky strategy.[1] Badly-timed acquisitions 2007 into 2008, [2] (plus inadequate due diligence?) and not brought under tight control, [3] in an industry which demands it (contracting, sub-contracting, [4] very high cost of sales, cut-price competition at times, impact of geology and weather on [5] costs etc). Plumbing division acquisition still has poor financial controls 3 years later.

The Finance Director incident looks incompetent [6] – panic cover up or scape-goating?

Unlike rest of industry, which out-sources as much as possible to help cope with volatile work-load, company had mainly own direct labour force. [7]
Apparently slow response to banking crisis and economic down-turn [8] – big house-builders got an early warning and started reacting in Summer 2007, [9] and survived. We know this is a cyclical industry, early into any recession. [10]

Opportunity to exploit the demand for social housing work which, until 2010 was relatively unaffected by the general housing down-turn [11] – re-balancing the business.

Did not run the business ruthlessly for cash [12] when the down-turn hit – working capital a big failing here, [13] (capex not an issue here), even stop all dividends if a matter of survival. [14]

Financial PR was disastrous [15] - company either could not forecast its own business well enough or thought it could bluff the market. [16] Apparently over-confident attitude to the City in the midst of all this is not very clever unless you [17] are absolutely confident that you are right – then several profit warnings in 2010! [18] Bland re-assurances and talk about more acquisitions in 2009 and even 2010 clearly did not work! [19]

Maybe did not talk to bankers early enough, [20] openly and politely, and with a realistic survival plan. [21] Extra facilities, more-forgiving covenants to allow head-room and flexibility for the recovery plan would have helped. [22] Normal re-financing was due in 2012 so maybe unlucky [23] on timing – but why not raise the issue in 2007 [24] when the problems could clearly be put down to the banking crisis and fears of recession rather than to the company's incompetence.

Dominant entrepreneurial CE - running public company like a private one. [25]

Based on your answer to question 1a, the descriptive material and the summarised financials, do you think that the failure of the company was inevitable? Give your reasoning and evaluate as far as you can the effect of external factors versus factors within management's control.

12.6 mins (7marks)

Marking scheme - ⅓ mark for each good point.

Company badly hit by the recession [1] with drop in gross margin [2] plus huge extra-ordinaries in [3] 2008 and a 29% drop in sales in 2009. A further 14% annualised fall off in sales in 2010 first half plus drop in profit plus exceptionals again, so EBIT loss in 2010.

Internal cash flow negative by [4] 31.1 millions 2008-2010, with working capital the main culprit (outflow of 46.8mill) plus a £20 million acquisition (deferred [5] consideration?). Capex not a big issue, divis trimmed in 2009, low tax, low interest. So debt increased by £50 mill in 2.5 years, but mainly in 2008. [6]

Gearing is now high enough and well up on 2007. The 2007 acquisition was funded from internal cash flow plus debt. Interest cover is still OK on P&L basis [7] but other credit ratios much worse in 2010 (cash cover negative, debt/EBITDA [8] 3.7 times , years to repay based on retained profit now 40 years!).

Share price on disastrous slide since 2007. [9] The profile of performance and share price behaviour would be typical of many [10] if not most businesses in 2008 and 2009, except that most are now showing signs of recovering in 2010. [11] Maybe the recent sector failures [12] and the impact of the new Government's plans on this [13] sector in particular are extenuating circumstances.

Despite the [14] claimed headroom in bank facilities the debt situation had deteriorated fast (£61mill debt at June 2010 and requested up-lift of facilities to £101 mill is even more alarming) [15] - this left the banks rather nervous and apparently uncooperative? [16]

The company clearly was in the eye of the storm from late 2007 onwards, so external factors played a big part, [17] but the dangerous consequences of the rapid acquisitive growth strategy are also [18] evident. The descriptive evidence of an acquisition (or acquisitions) not yet sorted out, poor financial control, suspicion of [19] creative accounting, suspended finance director later to be exonerated, confident statements from management despite the emerging adverse financials and an under-estimate of the stock market's requirements and power – maybe smacks [20] of a small company management (one-man rule?) and mentality in a plc skin! [21]

So I think the demise was possibly not inevitable – we have seen many examples of companies in dire situations, whether or not of their own making, that survived [22] by taking appropriate drastic action but this requires support from counter-parties. When the business situation and the financials started deteriorating the company was not heavily indebted but it soon became so.

QUESTION 2 **19.8 mins (Total 11 marks)**

A recent article on private equity indicated that for a sector with systemic risk 25% above average PE investors could now expect a lower IRR return compared with the expected figure pre-banking crisis. This is based on a current 30% debt component instead of the earlier 30% equity, debt interest rates of 12% now rather than 8%, and an non-quoted additional equity premium of 3% as against the earlier 2% (PE firms typically add this additional equity premium on top of the quoted-company CAPM formulation). It is assumed that the risk-free rate of 4.5%, a market risk premium of 5.0% and a tax rate of 28% remain unchanged. The holding period to PE exit is now expected to be typically five years as against the former 3 years.

Required:

a) Calculate the required equity returns and the WACC under each of the two scenarios. Comment on the different figures for the required equity returns and WACCs.

9 mins (5 marks)

Marking scheme – there are 16 detailed points/steps in the calculations, so ⅓ mark for each bit.

For an average company ungeared beta is about 0.8 [1] so this company has ungeared beta of 1.0. (0.8 - 1.25) [2]

<u>Pre-Crisis</u>
Geared beta for 70/30 debt equity = 1.0 x [1 + (0.72 [3] x 7/3 [4])] = 2.68 [5]
Required equity return = 4.5 + (2.68 x 5.0) = 17.9 +2% = [6] 19.9% [7]
WACC = (19.9 x 0.3) + (8 x 0.7 x [8] 0.72) = 10.0% [9]

<u>Post-Crisis</u>
Geared beta for 30/70 debt equity = 1.0 x [1 + (0.72 x 3/7)] = 1.31 [10]
Required equity return = 4.5 + (1.31 x 5.0) = 11.05 + 3% = 14.05% [11]
WACC = (14.05 x 0.7) + (12 x 0.3 x [12] 0.72) = 12.43% [13]

Summary

	Pre	Post
General beta	2.68	1.31
Required equity return	19.9%	14.05%
Cost of debt	5.76%	8.64%
WACC	10.0%	12.43%

WACC has risen quite [14] a bit with reduced leverage (Modigliani and Miller with tax shelter, but also with higher cost elements to both debt and equity). [15] Cost of equity reduces with reduced leverage risk, but partly offset by higher un-listed company risk premium. [16]

Required:

b) Calculate the annual EV growth rate required under the two scenarios to deliver the respective compound rates of return to PE investors. Assume that 10% of the debt could be repaid annually out of cash flows under the earlier regime and 20% under the new regime. Summarise the risk/return implications for PE investors of the changes.

10.8 mins (6 marks)

Marking scheme – There are 16 points but a difficult sub-question, so ½ mark for each good point.

Pre-Crisis
Assume 100 of equity [1] and 233 of debt. Equity value needed to grow by [2] 19.9% compound over three years to [3] 172 (72%). Debt reduces by 30% [4] over three years i.e. by 70 to 163. [5] EV therefore needs to grow to 172 +163 = 335 [6] i.e. compound growth rate of 3rd root of 335 / 333 = 0.2% [7] (the benefits of leverage!) [8]

Post Crisis
For 100 of equity, debt would now be 43 [9] (70% and 30% respectively).

Equity value needed to grow by 14.05% [10] compound over five years to 193. [11] Debt reduces by 70% [12] over five years i.e. to 0. [13] EV therefore needs to grow to 193 + 0 = 193 [14] i.e. compound growth rate of 5th root of 193 / 143 = 7.8% [15] (a bit more real work to do!) [16]

Additional Note:
Assuming loan repayments have to come from extra profit rather than liquidated assets;
Rate of return required (year 1) previously = WACC of 10% + (8% x 70%) = 15.6%
Now = 12.43 + (15% x 30%) = 16.93%.

QUESTION 3 **14.4 (Total 8 marks)**

A recent article in The Treasurer highlighted the recent revival of the corporate capital market for debt-equity hybrids, due to “low swap rates, the absence of bank issuers, greater transparency of Moody’s revised methodology and reduced structural complexity”

Required:

a) What are hybrids? Summarise the characteristic features of hybrids.

5.4 mins (3 marks)

Marking scheme - ⅓ mark for each good point.

Short answer – has some of the characteristics of both debt and equity. [1] Looks like equity to lenders, [2] subordinated except to ordinary shareholders, [3] but classed as debt by the [4] rating agencies, and interest is tax-deductible. [5] Fixed coupon [6] but with flexible [7] terms and conditions.

Debt instruments with down-side protection [8] and upside potential via equity rights. [9]

b) Summarise the advantages to the corporate issuer of hybrid capital market instruments. Who would be likely to make use of them?

5.4 mins (3 marks)

Marking scheme - ⅓ mark for each good point.

Cost effective financing [1] – tax-sheltered [2] bond-related cost for quasi-[3] equity
Bolsters ratings [4] – equity-like capital
Emerging component in acquisition finance [5] - latest example of classical use of quasi-equity [6]
Quasi-equity for companies with no access to the equity [7] markets or not wishing to dilute existing shareholders. [8]

c) Summarise the pros and cons of hybrids for investors.

3.6 mins (2 marks)

Marking scheme - ⅓ mark for each good point.

More security and transparency for investors with Moody’s revised methodology. [1] Appetite for higher [2] yields given current low interest rates on cash and delivered via a fixed coupon, [3] attractive to traditional [4] fixed income investors, and with superior yield to equities, but for reduced level of risk [5] unrated credit risk [6] Upside depends on equity performance [7]

QUESTION 4 **23.4 mins (Total 13 marks)**

Required:

a) What are the relevant considerations in deciding a company's dividend policy, both practical and theoretical? Support your answer with illustrations of the metrics used to decide the appropriateness of dividend policy together with numerical examples.

10.8 mins (6 marks)

Marking scheme – there are 20 points so ⅓ mark for each good point (but penalties if no metrics or numerical examples).

Sustainability and [1] growth potential – payout [2] ratio should be related to risk and hence volatility [3] of earnings eg earnings/dividend cover of 2.5 [4] (40% payout) allows for average volatility of earnings.

Dividend policy, once decided, should be maintainable [5]

Also cash re-investment requirements [6] of the business eg growing companies maybe 25% [7].

Growth potential of the business [8] – ability to deliver share-price growth rather than cash dividends, as well as re-investment requirements eg zero dividend yield [9] 15% growth

"Clientele effect" [10] – balance between shareholders requiring (taxed) cash dividends [11] to meet scheduled cash outgoings (many key investing institutions) eg "yield stocks" [12] yielding 5%, lower capital gain on equity, versus preference for share-price appreciation (delayed tax effects). [13]

"Dividend irrelevance" [14] – first requirement is to earn an appropriate total rate of return, on equity, the dividend decision being secondary, in that profitable companies can pay out dividends for which they do not have cash but can fund by borrowing [15] or new share issues. (Also shareholders can sell shares to create cash income if no dividends are paid but share price is increasing). But the first can go against the grain of prudent [16] corporate financiers who like to hang on to cash generated (and the latter against the thinking of investors who don't like to touch their "capital". And tax differentials can favour distributions or re-investment.

"Signalling effect" [17] of dividend announcements – i.e. the information content, reflects the degree of management confidence [18] in future prospects.

Availability of distributable profits (accumulated) [19] Availability of parent company cash [20]

b) What are the most important considerations, from the shareholder's point of view, when evaluating a company's dividend policy. Again, use numerical examples of shareholder metrics to illustrate your answer.

7.2 mins (4 marks)

Marking scheme - ⅓ mark for each good point

Whether he wants yield [1] or capital growth, [2] relative to his tax position [3] and committed cash outgoings. [4]

Confidence [5] in the level of cover, given the perceived risks of the company, [6] and the level of earnings

Stated dividend [7] growth policy and whether it looks sustainable. [8]

Past record of dividend payments [9]

Transaction costs of share dealing mitigate against releasing cash from sales instead of cashing a dividend cheque. [10]

Position on realising annual capital gains by selling shares. [11]

Peer group/sector comparisons [12]

c) How does the market react to a reduction in dividends, which have been quite common since 2008?

5.4 mins (3 marks)

Marking scheme - ⅓ mark for each good point

Generally with great dismay [1] – this is a desperate [2] but necessary [3] step for companies with severe [4] profit and cash-flow problems.

Usually disastrous for the share price. [5]

Even worse if totally unexpected [6] – no prior profit warnings

If problems are severe and well known [7] the decision to cut the dividend may result in an increase in the share price – relief that the company is biting the bullet at last. [8]

And if the dividend cut, together with other steps, [9] means that the company can probably be saved / turned around. [10]

Widely known that 2008-9 exceptional circumstances - companies conserving [11] cash by all means possible, given shortage and re-pricing threat of bank [12] finance, also general recession. [13]

QUESTION 5 **21.6 mins (Total 12 marks)**

Sir Mikael Klein has pledged personally owned shares in the airline he created as security to finance a property for his embryo hotel chain. He has, at the same time, executed a collar equity option with the lending bank to reduce his downside risk on the property transaction by giving away some of the potential upside on the airline shares.

General points

- Sir Mikael is the principal in this transaction and not the Airline and the shares are his personal assets
- The loan is interest bearing
- The stock is collateral
- The "collar" is probably zero cost

Required:

a) What are the attractions and drawbacks of this arrangement for Sir Mikael?

12.6 mins (7 marks)

Marking scheme: about seven credible points to pass.

Sir Mikael cannot borrow unsecured and has had to use his shares as collateral but with this arrangement retains his voting rights and his dividend income.

If the hotel deal succeeds he may be able to refinance the £4m against the asset and/or the related income stream within the one year timeframe.

If the deal fails/can't be refinanced and the share value has fallen below 411p he can exit without additional loss.

Attractions for Sir Mikael:

- gets the loan
- retains dividend and voting rights
- floors loss
- zero cost option
- £13m existing facility is probably at LTV limit
- suits his risk appetite
- if deal is successful and adds value to property, can refinance after a year

Drawbacks:
- margin cost
- potential loss of upside on shares
- refinance risk at 1 year
- “cost” of collar (even if zero cost there is spread on options)

b) What are the attractions and drawbacks of the deal for IBG?

9.0 mins (5 marks)

Marking scheme: about five credible points to pass.

The bank has been able to lend to a sub-investment grade borrower without providing a conventional debt facility and attracting the conventional capital charge.

The bank also gets the upside of a rise in the share price and the spread on the options.

The bank has done the equivalent of a 1 year reverse repo with Sir Mikael with a large haircut and embedded a (probably) zero cost capital hedge for himself.

Attractions to Bank:
- secured loan, lower capital cost
- probably good margin
- big upside
- derivative business (options)

Drawbacks:
- potential loss
- refinance may fail

QUESTION 6 **23.4 mins (Total 13 marks)**

You are the newly appointed treasurer of Saturn Housing Association, a regulated "not-for-profit" charitable organisation, which builds social/affordable housing financed by Government grant and long term bank or capital market funds.

Required:

a) **Draft a template for appraising new development projects covering the key areas of analysis, evaluation and governance (approval and control of new development projects).**

16.2 mins (9 marks)

Marking scheme: (i) Reference to both business and financial risk analysis, sensitivity analysis, evaluation and approval process, control/oversight; (ii) thereafter, looking for some sense of an integrated approach.

Business/Non-financial Analysis

- Strategic Fit - fit with corporate policy and objectives
- Business Analysis - commercial rationale, pricing, client needs
- Technical Analysis - feasibility of site and build

Financial Analysis

- Cashflow/Investment Analysis
  - o assumptions
  - o measures (defined) eg: - payback
- NPV, IRR
  - o no one measure captures the full story
- Accounting Analysis - impact on P/L, B/S, KPIs. eg:
  - o profitability
  - o cover ratios
  - o covenants
- Financing - source, costs, hedging

Risk and Sensitivity

- Risk and Mitigants - key risks and measures to manage them
- Sensitivity Analysis - "what if" tests: normal, abnormal

Recommendation

- Based on synthesis of financial and business analysis

Format

- Standard Formats
  - Executive summary for Board
  - Intermediate detail for FRC
  - Full scale format for decision making and audit trail.

Board Level

- Main Board
  - Approve process ie policies, goals, methodology
  - Sanction or delegate depending on size, risk

- FRS
  - Define policies and goals
  - Endorse methodology
  - Review/advise on projects going to Board

- Audit - Police process

Treasury Level

- Treasurer
  - Devise project appraisal methodology
  - Determine IVR process
  - Manage and sign off IVR process

- Back Office - Monitor and report on project IVRs

Internal Audit

- Internal Auditor
  - Periodic audit of appraisal and IVR process
  - Periodic post-implementation audit

The Government response to the financial crisis has been to virtually cease to provide grant. To compensate, regulation has been significantly reduced and Housing Associations are being encouraged to be “entrepreneurial and innovative”. Saturn’s board and executive have wholeheartedly embraced this invitation, recruited the retired MD of a national housebuilder to the board and set up Devco to exploit market opportunities.

b) What are the risks associated with these new developments?

7.2 mins (4 marks)

Marking scheme: evidence of recognition of the high degree of execution risk and the concomitant necessity for tighter control and more rigorous oversight.

The strategy is to engage in 'for profit' residential property in competition with large corporates which are experienced in the sector.

Implementation is down to management recognised not to be innovative and entrepreneurial.

Target CAGR is 10% pa to double size.

In the current hostile economic environment this adds up to huge execution risk.

Therefore the rigour of analysis, evaluation, control and oversight of new development projects must be raised significantly and post-project reviews must be enforced with vigour and monitored at the highest expert level.

General

Several candidates mentioned the Risk Management Matrix as an appropriate framework for answering both parts of this question. However, none of these tried to apply it.

Note: - Part (b) of this question was answered noticeably better than Part (a).

QUESTION 7 **32.40 mins (Total 18 marks)**

Your company, a management buyout vehicle, is expanding globally from its domestic base. You are mandated to set up and manage a supply chain project aimed at achieving lower component unit cost and more effective distribution.

Required:

a) What business functions would you need to recruit to the team? 7.2 mins (4 marks)	**No of Mentions**	**b) What particular contribution would you expect each to make? 14.4 mins (8 marks)**
Marking scheme: judgement based on comprehensiveness of functions mentioned and credibility of contribution cited.		
• Procurement	4	identifying suppliers
• Quality control	1	ensuring quality standards
• Product design and development	1	altering design to accommodate suppliers
• Manufacturing and production	4	cycle times
• Production engineering	-	evaluating outsourcing
• Stock control	1	logistics of manufacturing and delivery lead times
• IT	1	controls/mis
• Distribution/logistics	1	logistics of delivery
• Marketing	4	customer requirements
• Treasury	4	eg fx risk, trade finance
• Management accounting	1	cost comparisons
• Finance	3	corporate overseas structures eg JVs
• Reporting/systems	-	developing and integrating information on the above
• Legal and regulatory	4	import/export, transfer pricing
• Tax	2	eg WHT

Given the current relatively low turnover, some of these functions may not yet be discrete.

Low scores for some functions, eg quality control, distribution/logistics, exposes some blind spots in understanding of the manufacturing process.

c) What are the treasury implications of the supply chain remit?

10.8 mins (6 marks)

Marking scheme: expect four or five credible justified, implications.

- much more fx activity to manage/hedge
- much more assessment of counterparty risk on new suppliers in terms of their long term viability
- trade finance to arrange if suppliers need letters of credit for working capital finance
- financing overseas investment in (assembly) operation, in joint ventures and possibly in more flexible arrangements like Rolls-Royce's Risk/Revenue Sharing Partnership (RRSPs)
- transfer pricing
- possibly, as team leader, agreeing KPIs and monitoring progress (in context of 5-7yr exit).

QUESTION 8 **18 mins (Total 10 marks)**

Required:

a) Is there a business case for adopting a policy of high ethical standards and corporate social responsibility, externally in relation to customers and/or internally in relation to staff?

9 mins (5 marks)

Marking scheme: expect a "professionally argued" response, as if responding to a question from a non-executive director at a strategic review.

General points

- Published ethical guidelines can have the advantage of raising public confidence in the company on the part of:
    - employees
    - commercial counterparties
    - regulatory bodies
    - government
- One (possibly cynical) view is that a high profile ethical policy may confer competitive advantage where the company's (retail) customer base is ethically sensitive:
    - eg, Co-op Bank
- A related view is that a rigorously applied code to govern (professional) counterparty relations may be much cheaper than having a legally enforceable system which has to be properly policed.

- A third view is that competitive advantage can be gained by operating aggressively at the borderline of what is legally permissible
- A fourth is that business ethics is essentially a necessary common-sense extension of a personal moral code and that righteousness brings its own reward.

Specific points

Public opinion is an increasingly important influencer of ethical standards, at least at the perceived level.

Regulation, especially in the EU, is another important driver.

However for companies operating globally there is a very wide spread of positions across the world on these two specific factors.

A current synthesis of views might go like this:

- a lot depends on the industry in which the company operates
- the country of operation needs to share the company's values
- senior executive sponsorship is critical
- political/regulatory support/reward is a key influencer eg carbon footprint, sustainability.

Part (b) of this question seeks the candidates view about whether or not the treasurer, who is just about to meet up with the main relationship banker for a routine periodic review, should reveal a potentially very material change in projected revenue which has only just been discovered.

b) What do you do and why?

9 mins (5 marks)

Marking scheme: listing of the major issues raised; credible suggestions about the way forward (short of resignation).

The treasurer has no time to check out with the sales director the likelihood of finding replacement sales to make good the short fall. The treasurer wishes to disclose to the bank but the finance director expressly forbids it. The question is firstly about whether to alert the bank about a future event which is still uncertain and risk over-reaction from the bank or to keep quiet about it during the meeting and then clarify the situation over the next few days; and secondly, if the treasurer considers disclosure a "must", how to act in light of the finance director's orders.

This situation raises legal, ethical, managerial and commercial issues:

- "disclosure of information on a timely basis"
- duty of care to bankers

- loan documentation: may include default clauses triggered by material adverse changes, failure to disclose and/or potential breaches
- realistically, can the lost revenue be replaced and will there be further reductions?
- should the finance director's order be disobeyed?

Firstly, regarding whether or not to alert the bank, the guiding principle should be not to mislead while at the same time not to unnecessarily alarm due to being overly scrupulous. The issue is a mix of commercial and ethical judgements for the treasurer: commercially, given the information available at the time, does he/she believe that a breach is probable? If so, ethically the bank should be informed. Clearly, in these circumstances it would help if a strong relationship based on mutual trust already existed between the banker and treasurer.

Secondly, if the decision is to disclose, how should this be handled managerially in light of the finance director's view? A realistic way out for the treasurer could be to decline to attend the meeting and to settle the matter immediately afterwards, involving the managing director if necessary.

EXAMINER'S REPORT – MCT GENERAL EXAMINATION

April 2011

Overview

QUESTION 1
This question tested understanding of the many dimensions of financial management. It required a mainly qualitative evaluation of the management performance of a failed company and an assessment of whether the failure was inevitable, based on the financial record and a historical narrative. It proved to be a good discriminator with the less strong candidates giving only partial analysis of the various problems and managerial responses e.g. missing out on the size and significance of the falling share price, related to successive profit warnings, or the effects of the "one-man-band" executive style.

QUESTION 2
This was a "straight-forward corporate finance question", requiring calculation of WACCs and rates of return to private equity investors for both highly-leveraged and less-leveraged capital structures. Unfortunately most candidates used the same levered or geared beta for both scenarios, which indicates a failure to understand the fundamental issue behind this question. This is worrying, especially as some candidates did try to use the formulae for gearing and un-gearing beta, often not very well. Also most candidates could not see the simple way to calculate the required growth in EV, based on the required equity value at exit, compounded at the required equity return, plus the exit level of debt. This question, therefore, revealed a failure to understand some of the most important practical corporate finance fundamentals.

QUESTION 3
This was a straight-forward discussion question on the nature of hybrid and their advantages and disadvantages for both issuers and investors. The wording of the question left scope for candidates to discuss hybrids based on a wider or a narrower definition. The question was generally answered very well and the better candidates achieved a more-balanced discussion of the following "trade-off" type of issues e.g. risk versus return, equity versus debt characteristics including tax, cash yield versus total return.

QUESTION 4
This was a straight-forward question on dividend policy, both generally and in the context of the recent economic climate where we have seen dividends cut. The question asked for a review of both theoretical and practical perspectives. This proved to be a good opportunity for the better students to shine by displaying the depth of their knowledge and understanding, and the rest to do OK. The less strong students were not so good at the two sub-questions, which asked how shareholders would evaluate a company's dividend policy and how the market reacts to a cut in dividends. The last, absolutely critical question, in particular, revealed whether candidates have a fairly superficial understanding (answer –

"they would not like it") or a more sophisticated framework (answer – "they would not like it but, if company was essentially sound but suffering profit down-turn because of the recession and cash-flow pressures because of non-availability of reasonably-priced bank finance then a cut might actually protect shareholders' long-term investment etc etc"

QUESTION 5

This question tested candidates' ability to unpick complex products and the attractions of the various features to each counterparty . . . a scenario often encountered by treasurers when dealing with banks. The transaction is essentially a loan to an individual secured on shares he owns. The individual buys a put option on the bank for the shares which limits his loss if the deal underpinning the loan goes bad: to reduce the cost of the put option the bank buys a call option on the individual's shares, which gives the bank some upside if the shares do well . . . an equity collar option. The benefits for the borrower were better understood than those for the lender. There were also some fundamental misunderstandings, eg: that the loan was to the company and that the company was pledging its own shares; that the loan was interest free and that the bank's return was wrapped up in the options somehow.

QUESTION 6

The first part of Question 6 required candidates to draft a template for analysing, evaluating and controlling, large, new "not-for-profit" (social/affordable) residential housing projects. The second part described an economic environment akin to the present-day UK (2010-11), where the strategic response of the social housing entity featured in the question is to expand into market-priced residential housing development in order to cross-subsidise the social housing: this part required candidates to identify the risks associated with this strategic shift. Responses to the first part relating to the metrics were noticeably weaker than those relating to the second. The draft template [part (a)] proposed by some candidates made relatively little reference to business risk under "analysis" and to financial metrics under "evaluation"; however, responses to part (b) picked up very well on the huge shift in risk management, commercial culture and execution expertise required.

QUESTION 7

This question was about improving supply chain financial efficiency in a manufacturing company. It was designed to test candidate's awareness of the holistic nature of projects which may seem on the surface to be primarily financial and the consequent need for a multi-disciplinary approach. This question was foreshadowed a few sittings ago by one about "working capital" efficiency: responses to the current question were much improved in terms of understanding the enterprise-wide implications.

QUESTION 8

The first part of this question addressed a general issue about ethics in business and the second part focussed on a specific scenario. The general issue is whether there is a business case for "good citizenship"; the overwhelming response was that there is, because of public opinion and also changes in EU regulation. This is in marked contrast to the largely contrary response when this question was asked previously in the mid-nineties. The specific scenario was about whether or not a treasurer at a routine meeting should alert the relationship bank about a potentially material development with negative impact on sales which has only just now become apparent: opinions were divided.