TREASURY
EXCELLENCE
AS STANDARD

ACT PAST PAPER

Diploma in Treasury Management (AMCT)

Unit 1: Corporate finance for treasury

April 2020

This is a past paper for Unit 1 of the Diploma in Treasury Management (AMCT)

Based on the syllabus assessed from 01 January 2019 to 31 December 2020 that was assessed in a live environment in April 2020.

INTRODUCTION

This past paper has been produced by the Assessment Department at the Association of Corporate Treasurers (ACT) to assist students in their preparation for the Diploma in Treasury Management assessments. It contains a past exam for the specified unit as well as past answers. Ideally, students should have completed the majority of their Diploma in Treasury Management studies for Unit 1 before attempting this past paper.

Students should allow themselves 180 minutes to complete the exam plus an additional 15 minutes reading time. They should then review their performance to identify areas of weakness on which to concentrate the remainder of their study time. Although the past exam in this guide is typical of a Diploma in Treasury Management assessment, it should be noted that it is not possible to test every single aspect of the syllabus in any one particular exam.

To prepare properly for the examination, candidates should make full use of the tuition options where available and read as widely as possible to ensure that the whole syllabus has been covered.

ASSESSMENT TECHNIQUE

This paper is a professional paper that as well as testing theory expects application to practice at an operational level.

The best way to approach written assessments is to work methodically through the questions. Candidates should not spend too much time on any one question if you are struggling to think of an adequate answer. Remember you can flag any question to come back to later should you want to continue your way through the exam.

When all of the questions have been answered, it is prudent to use any remaining time to go through each question again, carefully, to double-check that nothing has been missed. Altering just one response could make the difference between passing and failing.

Please ensure you show your workings within your answer when prompted as this means there are marks available for the workings out. You will be able to make rough workings on a piece of paper during the exam and on screen should you wish to, however these will not count towards your final mark.

ASSESSMENT INFORMATION AND TEST SPECIFICATION

The Diploma in Treasury Management assessments for Units 1 and 2 each have 4 written questions, of which you must answer 3, and will involve a pre-seen case study workbook that is released no later than two weeks prior to the assessment date. The papers will be split into sections A and B and can be made up of either one case study or two case studies; each unit exam is worth a total of 100 marks. For the purpose of this past paper the questions follow each case study.

Diploma in Treasury Management assessment test specification:

Section	Amount of questions	Marks available
Section A	1 case study based question	50
Section B	3 shorter case study based questions, of which candidates chose to only answer two	50
Total	3	100

Under exam conditions, **3 hours** (180 minutes) is allowed for the Diploma in Treasury Management assessments plus an additional 15 minutes reading time.

When you take your actual exam, you will be sitting online using your own PC/Laptop. You have access to an online scientific calculator, but for the purpose of this past paper, you may use a non-programmable scientific calculator.

In order for you to determine how well you have performed, sample mark schemes are provided after each question. Please note that these are mark schemes only and not model answers. They provide lists of points that are expected to be covered within answers, although the content of your answers must be much more detailed (satisfying the command word used in the question, for example 'analyse'). As with all mark schemes, the content is indicative only, i.e. the lists of points featured are not exhaustive. It is highly likely that there are other perspectives and, provided these are valid and supported fully, marks would be awarded for these in a live exam. There are also references to the relevant Learning Outcomes if you need to revisit the associated material.

SECTION A – 50 marks

Answer the ONE question in Section A. This question tests knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level.

Total available for Section A: 50 marks

Question 1

Nobark Background

Nobark Mobiles (NM) is a leading Indian mobile phone company headquartered in Bangalore.

NM was established in 2009 with an aim to bring the benefits of Smartphone telephony to the masses. Within a short span of time, NM has become the leading Indian mobile brand. It operates only in India, a country which has one of the fastest growth rates in mobile device consumption. NM reaches out to people across the length and breadth of the country, with over 92% penetration across the Indian continent.

Initially NM was a joint venture of New Delhi based Ajania Group and Bengaluru based TRM Group. In 2015 NM gained a stock market listing.

NM has over 1,000 service centres across India and was voted amongst the top "Most Trusted Mobile Phone brands" by Brand Trust Survey and Brand Equity Trust Report.

New product development – NBX Gold

With a strong focus on promoting the country's indigenous products, leading home grown brand NM plans to launch a new feature-loaded phone.

The 'Make in India' and 'Made for India' range of NBX phones offer best-in-class features to consumers, at affordable prices. The new NBX Gold is priced at INR1,000 and would be available in the Indian market from August 2020.

"The NBX Gold is a feature rich phone aligned with our brand's commitment to offer innovative technologies at reasonable price points. We believe customer satisfaction is what matters at the end of the day. We have been serving India with the best of customised phones for the past 10 years and wish to keep the journey going. This new series complements our customer-centric strategy to offer utility services, without compromising on either style or affordability. In our country, a considerable part of the population still uses feature-phones and, therefore, it is important for us to carefully curate products that are in line with their aspirations", said the MD.

Product development financial – NBX Gold

The new phone will be developed incurring research & development (R&D) expenditure of INR200m. However, the project lead notes that, given some unknown manufacturing costs and escalating fees for social media stars to promote the phone, there is the potential for these costs to increase.

A market research survey completed by NM at a cost of INR10m has produced favourable results with the market prepared to pay a market high price for a phone that could potentially provide significant additional features compared to rivals.

The following further information is available in respect of the project:

- The new project / expected demand for the NBX Gold is five years
- A net working capital investment of INR30m would be required to be made at the start of the project. This will be wholly recoverable at the end of five years.
- NM plans to sell each phone for INR1,000, and expects an annual demand of 0.5 million units.
- The total variable cost of each phone has been estimated at INR700.

Financing

Internally and externally there has been significant pressure on treasury to take on more debt, especially given the larger debt profile of peers such as Vodafone and Liberty global. The minutes of the latest board meeting also provide an insight into the view of the board who were quoted as saying; "Our peer group have more debt, debt is cheaper, debt leads to a lower WACC and therefore higher value for our shareholders".

The board has signed off on the funding for the development and other associated costs of the NBX Gold to be raised entirely through debt.

The commercial director (the project lead for the new development and sales of the NBX Gold) instructed treasury to use the cost of debt as opposed to NM's WACC, stating the use of WACC is irrelevant in this case.

Current financial structure and forecasts

Balance sheet extracts

Instrument	Description	Total nominal/face value (INR)
Ordinary share capital	nominal value per share INR1	50,000,000
7% Preference shares irredeemable	INR1,000 face value	100,000,000
5% Bonds five years until maturity	INR1,000 face value	80,000,000

A final dividend of INR3.0 per share for the current financial year has recently been announced. NM's shares are just about to go ex-dividend.

Total full year dividends for the last six financial years have been as follows (INR):

Year	2014	2015	2016	2017	2018	2019
Dividend per share	1.5	1.8	2.0	2.2	2.3	2.5

The corporate tax rate is 34.6%, payable in the year in which the profit is earned.
The current share price is INR80, the preference share price is INR1,100, and the bond price is INR1,050.

Q1	(a) Calculate NM's weighted average cost of capital (WACC) showing your workings. Within your answer you are also required to evaluate the appropriateness of using NM's cost of debt or WACC to appraise the NBX Gold development proposal.	18 marks
	(b) Critically evaluate the theoretical and practical accuracy of the board's view that NM's debt is cheaper than its equity.	14 marks
	(c) Recommend and justify whether the project should go ahead. Include in your answer an appropriate sensitivity analysis of the number of phones sold and the development costs.	12 marks
	(d) Recommend and justify how the sensitivity analysis you have undertaken in part (c) can be improved.	6 marks
		Total: 50 marks

Q1 answer

(a)

Cost of equity	Current share price INR	80
	Dividend INR	3
	Ex dividend share price INR	**77**
	Dividend growth	**12.25%**
	D1	3.37
	K_e	**16.62%**
Pref Shares	Preference share market price INR	1,100
	Coupon rate	7%
	Coupon INR	70
	K_p	**6.36%**
Bond	Bond market price INR	1,050
	Bond face value INR	1,000
	Maturity (years)	5
	Bond coupon	5.00%
	Bond coupon INR	50.00
	IRR	**3.89%**
	K_d (post-tax)	**2.54%**
WACC	Number of shares in issue (m)	50
	Market value of equity (INRm)	4,000
	Market value of debt (INRm)	84
	Market value of preference shares (INRm)	110

12 marks for WACC and 6 marks for a discussion on the use of K_d vs WACC

	Total (INRm)	**4,194**
	Weighting of equity	95.37%
	Weighting of debt	2.00%
	Weighting of preference shares	2.62%
	WACC	**16.07%**

Coupons paid by the subject company on its bonds are INR 50 as shown above and these cash outflows are eligible for tax advantage that is available to the extent of taxable profits. These actual cash outflows should be discounted first to yield an IRR of 3.8872%, which post-tax is 2.54%. Employing the after-tax adjusted value of cash outflows is not reflective of the actual situation. It provides a lower post-tax cost of debt as it is based on lower cash flows. It is also not correct.

Having calculated WACC answers should then evaluate the validity of using WACC or K_d as the discount rate. Key points include:

- The use of WACC may not be appropriate where the development of the NBX Gold is not aligned with the same risk profile as the existing business. If the new project is more risky then this will not be taken into account if WACC is used as the discount rate. In this case the size and development of a new phone (and selling at a market high price) could suggest that this project is not 100% aligned with the existing risk profile of NM, however it could well be not too far off.
- Better answers would note that given the discussions about increasing the amount of debt, it would seem there will be some significant changes in NM's capital structure (given the funding need of the new project and pressure to gear up) as such using NM's existing WACC will need to be changed.
- Answers could note that as companies move towards their optimal capital structure, it is not a smooth process and there will be times where changes occur in stages.
- The cost of debt will not reflect the significantly higher returns that shareholders require and using Kd whilst meeting the cost of debt will not add shareholder value (or economic value added).
- Using cost of fund raised now (ie using the cost of debt as opposed to WACC) could lead to projects being accepted that are inferior simply because they were evaluated at a lower discount rate.
- Better answers would note that it could be better to use an average cost of a pool of funds linked to projects of similar risk.

Other relevant points included will be considered with appropriate marks being made available.

(b) The drivers NM's weighted average cost of capital (WACC) include:
- the current market values of each source of capital
- the expected investment return requirements of each group of investors
- NM's choices on its capital structure
- tax relief, if any, on the servicing costs of each source of capital.

Current market values and required investment returns are substantially driven by investors' perceptions of the risk of the NM's underlying business and of its financial structure.

	Interest and other debt servicing costs will generally be deductible for tax, resulting in tax shield benefits. **Optimal capital structure: guiding principles** • efficiency. Debt is nearly always cheaper than equity and the capital structure should therefore include as much debt as the company is willing to afford, based on future cash flows. It is important to recognise here that affordability may be limited by industry sector. Companies in industries with stable cash flows (such as the telecoms sector which NM operates in), where the predictability of their cash generation is high, will inevitably be able to afford more than those in volatile industry sectors • flexibility. When thinking about the optimal capital structure and affordability levels, it is vital to leave headroom to absorb the impact of any unwanted internal or external events – such as operational challenges or changes in interest rates – on cash flows and profit margins. This provides NM a safety barrier that is more efficient than holding a stockpile of cash • liquidity. Given the uncertain world in which treasurers operate, it is important to ensure that the company can tap different markets for liquidity as and when required. Having access to a broad funding toolkit will assist greatly in achieving the optimal capital structure and, indeed, for adjusting it over time. In addition, the broader the access to liquidity, the more routes that are available in the event a stress closes some routes to market. Answers should then address M&M theory – focusing on their 3rd proposition. M&M's third and final proposition incorporated the cost of financial distress. High proportions of debt can lead to the risk of financial distress, which has high associated costs. Financial distress is where obligations to creditors are not met or are met with difficulty. A firm might not reach the stage at which it is liquidated, but it may, in going through a financially stressful period, alienate suppliers, customers, employees and creditors – not to mention providers of debt and equity. This can have a devastating effect on the firm and some common implications are: • suppliers insist on cash on delivery, thus making a cash shortage worse • customers desert the firm, worrying about its ability to deliver • employees seek other work, the better ones being most likely to succeed in finding it • debt providers impose restrictions on lending and demand more contact with management • other creditors become wary • management is distracted by the crisis, risking making matters worse • in extremis, of course, the firm will fail. The vulnerability to financial distress varies depending on the type of business. If the sales level of the industry varies greatly with the level of activity in the economy as a whole, the susceptibility for running into trouble is raised. This is exacerbated when the cost structure shows a relatively high proportion of fixed, rather than variable costs. Industries with more stable cash flows can accommodate higher debt levels than those with more variable cash flows. If the costs of production are mostly fixed (so that NB has high operational gearing), then the firm is more vulnerable to a downturn in business. It may not	1 mark per developed point

be advisable to add high financial risk, through high gearing, to an already high business risk.

Modigliani and Miller's work indicates that a firm's WACC initially falls as debt levels rise from very low levels due to the tax benefits of debt. As debt levels become too high WACC rises again due to the greater costs of financial distress.

Firms try to reduce their WACC because this has a positive impact on the value of the firm. Firms change their WACC by changing their capital structure.

There is an optimum level of gearing which achieves a WACC that is as low as is consistent with the long-term security of the business. For example, in a low growth firm, if the capital structure is sub-optimal, adjusting capital structure to minimise WACC and so achieve growth in firm value can be particularly valuable.

However, establishing what the optimal capital structure is for NB is difficult in practice. Given the lack of a comprehensive quantitative theory that includes the costs of financial distress, NB should adopt a more pragmatic approach.

One such approach is to target a particular credit rating, reflecting the market's and the credit rating agency's opinion of the appropriate level of risk. In turn, the credit rating will be strongly influenced by traditional measures of gearing, as well as other assessments of course.

The credit ratings agencies evaluate a wide range of factors in arriving at their conclusions, and NB's credit rating provides a visible benchmark against which its cost of capital can be set.

However, there are those that argue that this puts too much of the responsibility for financial management into the hands of the credit rating agencies and that financial managers should make their own decisions.

Many companies choose a debt level which is at the lower end of the optimal range. The benefits of this are the flexibility of action in response to market opportunities and the avoidance of the risk associated with equity price falls. The costs in adopting such an approach are relatively small, as long as the divergence from optimum is not too great

Better answers will also discuss

- Agency costs
- Financial slack
- Finite tax capacity

A 'pecking order' approach describes pragmatic and opportunistic responses to capital structuring.

According to the pecking order theory, NM will access available new finance that is cheapest and easiest to issue first. Reasons for adopting a pecking order approach in practice include:

- issuing shares is seen as a sign of trouble, even as an act of desperation
- debt is relatively easy, and potentially private, to raise
- managers follow the line of least resistance. To use retained earnings managers need to provide little explanation to outsiders concerning the uses to

which the money is put. To borrow, they need to explain how the funds will be used. To issue new equity would require even more justification and cost.
From a treasury perspective, the trade-off theory of capital structuring is currently the most widely referenced and applied. Under the trade-off theory, the optimum capital structure is sometimes defined simplistically as the capital structure which results in the lowest weighted average cost of capital (WACC).
Trade-off theory suggests that the capital structure of a firm is important when any of the following conditions apply:

- debt financing is more tax efficient than equity funding, thus resulting in a lower tax bill
- there are costs associated with financial distress when a firm is perceived to have a higher probability of default
- the operating and investing decisions of the managers are affected by what is on (or off) the balance sheet
- information asymmetry leads to investors relying on their interpretation of signals to understand the prospects of the business: 'signals' in this context being capital structure decisions such as the choice of debt or equity financing, and dividend payouts.

Further considerations include

- Market conditions
- Regulations.

Other relevant points included will be considered with appropriate marks being made available.

(c)
Marks to be awarded for correct treatment of relevant/ irrelevant cash flows:

The following should be excluded:

- Market research costs (sunk cost).
- Interest charges on debt (cost of debt is included in the discount rate).

	INR
Selling price	1,000
Variable cost	700
Incremental cash flow	300
Number of units	500,000
Profits	150,000,000
Tax	51,900,000
After tax profits	**98,100,000**
Initial outlay	230,000,000
Working capital recovery	14,240,370
NPV	90,684,400
NPV plus WC Recovery	**104,924,770**

1.5 marks for exclusion of cash flows, 1 mark for incremental cash flow, 1.5 marks for after tax profit, 4 marks for Overall NPV (including AF calculation), 2 marks for each flex

Note: NPV = PV of after tax profits x AF @ 5 years at WACC less initial outlay + PV of working capital recovery (as below).

	(3.26895 x 98,100,000) = 320,684,000 Less initial outlay 230,000,000 Plus NPV of WC recovery 14,240,370 (0.47468*30,000,000) NPV **104,924,770** Sensitivity analysis Key variables : Sales volume and initial outlay. Sales Volume For NPV calculated above, to be zero, the PV of net profit x AF is 320,684,400 - 104,924,770 = 215,759,630 So % fall would be 104,924,770/320,684,400 = 32.7% fall in profits because of lower sales volumes, which gives a significant amount of flexibility. Development costs Development costs must rise to (230,000,000 + 104,924,770) = = 334,924,770 or a 45.62% increase in development costs, which gives a significant amount of flexibility. Better answers might also undertake a payback analysis and marks would be awarded. Other relevant points included will be considered with appropriate marks being made available. (d) • The main limitation of this type of analysis is that it examines the effect of a change in only sales or development costs at a time • All other variables are kept constant • In reality a change in one variable is likely to be accompanied by changes in other variables as well. • Another problem is that the sensitivities of any two variables are not necessarily comparable with each other. • Due to; capacity constraints there will be no scope for any increase from the estimate. So, if demand for the NBX Gold is much higher anticipated it will not result in increased sales. However, if there is excess demand, t may be possible to raise revenue by raising prices. • Hence, it is also advisable to consider the likelihood (or probability) that a particular variable will, in fact, deviate from the estimate. • More variables than those outlined will need to be taken into account such as inflation, skills required etc. Other relevant points included will be considered with appropriate marks being made available. **Syllabus ref:** LO1,4, 5, 6, 7, 8, 14,15	1 mark per developed point
		Total: 50 marks

Section B – 50 marks

Answer TWO of the following THREE questions. Questions test knowledge, analysis, application, insight, evaluation and justification as appropriate to level descriptors. This is a professional paper and application to practice should be at 'management' level. Candidates are expected to be able to synthesise knowledge from different elements of the syllabus rather than be tested on discrete areas.

Question 1

Worksop Beverages Background

Worksop Beverages plc (WB) is a multinational producer of alcohol and beverages. It is one of the world's largest producers, with interests and distribution agreements across six continents. WB has been highly acquisitive in the past and is a big user of financial markets and derivatives to fund its operations and manage its foreign exchange, interest rate and commodity risks.

Business and geographical analysis

Africa and Asia

WB's operations in Africa span 31 countries. South Africa is WB's most established market. In China, WB's national brand, Artic is produced in partnership with China Resources Enterprise Limited, with WB owning 49 percent; this is the leading brand by volume in China. WB has recently agreed to sell its interests in Artic to China Resources (Holdings). WB is also the second-largest producer in India and has joint ventures in Vietnam.

Australia

WB has joint ventures in Australia. In September 2011, the board of OzBev Group agreed to a takeover bid by WB, valuing the company at AUD9.9bn (USD10.2bn; GBP6.5bn). The OzBev Group is now a direct subsidiary of WB.

Europe

WB has extensive operations located throughout Europe and has rights to produce and sell a number of leading brands from other producers.

Latin America

WB first entered the Latin American market with the acquisition of Dervecería La Donstancia from El Salvador and Dervecería Dondureña in Honduras, making WB the first international producer to enter Central America. Since then, WB has expanded its Latin American operations into six countries, including Colombia, Ecuador, Panama and Peru.

North America

On 9 October 2018, WB and Cool Beverage Company announced a joint venture to be known as WBCool. The combined venture is headquartered in Chicago, Illinois.

Overall WB can be said to be highly acquisitive and is growing significantly in developing countries.

Summary financials

	2018 GBPm	2019 GBPm
Turnover	10,380	10,678
EBIT	3,414	3,645
PAT	2,462	2,712
Gross Debt	9,164	9,064
Net debt	7,311	7,111
Shareholders' funds	5,125	5,825
Market cap	29,370	30,285

Corporate structure banking relationships

The business has 90 subsidiaries and exposure to over 25 currencies. WB has 13 relationship banks and 65 non-relationship banks. 65% of WB's debt is market based and the remainder provided by relationship banks.

Q1	(a) Critically evaluate the key factors for WB to consider when choosing a relationship bank. (b) Critically discuss how WB can manage its existing bank relationships most effectively.	13 marks 12 marks
		Total: 25 marks
Q1 answer	(a) Given the significant global operations of WB, the choice will be between: • larger banks providing comprehensive services, such as cash management and foreign exchange, with relatively few branches in other countries but with an extensive operation in territories important to the multinational. An example here could be HSBC, which is active in UK, Europe, and the Far East • local banks offering very good local coverage in particular countries in which the multinational operates, but limited presence in the company's home country or major territories. Examples of banks with a strong 'local' presence which have negligible activity in Europe are: State Bank of India, Standard Bank in South Africa, Wells Fargo in the US. WB could adopt a combination of these approaches, selecting the more appropriate approach depending on services required in each region.	1 mark per developed point

This is evident in its number of banks which would have been built up through its global operations, acquisitions and need for local expertise.

WB should have a clear view of the services it requires from each bank and it is worth maintaining communication with banks to ensure that this is always the case. Services include not only lending, cash management and treasury products, but also corporate advice. Does WB expect the bank to comment on certain aspects of the company's strategy, or assist in answering corporate finance questions that the Board may ask from time to time? Some banks have the expertise to answer questions on strategy or corporate finance, but they will not provide such services free of charge. They will either expect to be paid a retainer fee (an annual fee for corporate advice) or expect their advisory services to result in additional business for the bank if a decision is taken by the Board to action certain financial proposals.

The criteria WB could use for selecting a bank, and for developing a long-term working relationship, should including the following:

- the amount of financial support (balance sheet support) the bank is prepared to give. Financial support means not only the level of committed borrowing facilities from the bank but also the willingness of the bank to support business development such as acquisitions or capex which may demand substantial funding
- the capital adequacy and credit rating of the bank. This is particularly important when the general level of credit quality for banks is relatively low, such as in a period of recession or slow economic growth. If a bank is financially stretched, it might be unable to extend sufficient credit lines to its corporate customers
- the bank's ability to deliver good quality customer service and operate efficiently. Operating efficiency is particularly important; mistakes at the processing level need to be kept at a minimum to avoid management time being taken up with mundane matters such as the incorrect processing of cheques or the incorrect transfer of funds between bank accounts
- the bank's reputation and management quality. There is now a much greater awareness of corporate governance and the way that organisations are managed. Just as banks will be aware of the corporate governance practices of their large corporate customers, so too should corporates monitor the corporate governance of banks, and select their bank (or banks) accordingly
- the bank's sophistication. Banks should have sufficient capacity to match the key requirements of WB
- the bank's territorial spread. The bank should have sufficient territorial reach in its operations to match the corresponding

geographical diversity of WB's business, otherwise 'local banks' will need to be used in specific geographical locations

- the bank's product portfolio. Is it able to offer a proven portfolio of products and services to meet the requirements of WB
- the bank's ability to understand the business. For a good relationship to develop, the bank must be able to understand the business WB.
- the bank's ability to innovate. The corporate might want to select a bank able to offer WB new products or services
- the bank's price-competitiveness. The treasurer should be aware of the prices charged for products and services in the marketplace and ensure that the chosen banks remain competitive, although not necessarily the cheapest
- the bank's willingness to maintain (where possible) the same relationship manager for several years. It is frustrating when the relationship manager changes on a regular basis since on every occasion the treasurer will have to invest time developing an understanding of the business from a new relationship manager.
- Better answer may also discuss the growing role of Fin-techs.

Comparisons with other banks: Benchmarking should be used, and the bank's charges compared with those of other banks (difficult in practice without running a full-scale tender).

Bank fees: A corporate should be on the look-out for costs such as:

- float: how long does it take to obtain value for cheques, foreign currency receipts and other credit items banked
- ad valorem fees on remittances (mainly on international transactions) as these
- are often taken by deduction from the transfer itself
- credit interest rates. While not a cost, low credit interest rates represent an
- economic loss. Many banks offer relatively poor interest rates (if any) on credit balances.

Flexibility: Does the bank's service offering meet the longer-term requirements of WB? If necessary, how might the service be altered to meet the changing requirements of the corporate, and how much will it cost? Conversely, is the corporate making the best possible use of what the bank can offer? For example, a good relationship bank will always update its products (such as electronic banking systems) to remain competitive with other products that are available in the market and will work with its customers to maximise their utilisation.

	Other relevant points included will be considered with appropriate marks being made available. (b) Answers should initially discuss the pros and cons of bank rationalisation and its impact on treasury /business operations. Once a relationship bank has been selected, the continuing relationship must be actively managed. Both WB's and the bank's circumstances will change over time and their business strategies will evolve. Consequently, it is important that WB and the bank maintain a regular dialogue to ensure their relationship continues to work well as changes occur. While banks might organise themselves in many ways: to focus all of the relationship through a single account officer or to spread as many personal relationships between the company and the bank as possible, WB must also develop its own relationship management strategy. WB should determine the relationships that it wants to see, such as CEO-level contacts, CFO-level contacts, as well as operational-level contacts for addressing transactional matters. The relationship should be concentrated through the Treasurer who should oversee the whole relationship, otherwise it may deteriorate into a set of individual relationships that lack consistency of approach and messaging. WB should monitor the bank by: • keeping abreast of news on the banking sector • reviewing each bank's strategy with a senior bank manager • ensuring that ratings of the relationship banks are monitored on a regular basis • checking whether the bank's personnel changes on a regular basis • ensuring that each is clear about the exact relationship and expectations under different circumstances • monitoring service quality of each bank. Treasury management systems should be able to provide reports summarising the level of business undertaken on a bank by bank basis, and if a disproportionate portion of business is undertaken with one bank, the reasons for this should be documented and understood. This is done to avoid favouring one bank over others unless there is a very good reason, such as one bank offering consistently more competitive prices that cannot be matched by other banks. It is also worth keeping a record of all communications of a relationship nature with each bank, so that evolution of the relationship can be monitored and controlled.	1 mark per developed point

In the cash management arena, monitoring bank charges and tariffs is an important aspect of managing a banking relationship. The treasurer should periodically check that a bank's charges and tariffs remain reasonable and renegotiate terms with the bank as necessary, or be prepared to re-tender the business.

To make the relationship with its bank work well, WB must be aware of the bank's motivation in the relationship. Given their high cost base, banks are under pressure to make their corporate banking services as profitable as possible within credit constraints.

Ancillary business

Banks commonly find it difficult to create a business case from lending alone and so they will seek further, more profitable, business to justify the investment of the bank's capital.

The management of each party's expectations of what ancillary business is available, how much can be taken up and at what price, is extremely important. Ancillary business is really the root of modern relationship banking; the trust that the bank will be considered for ancillary business, and, if successful, will provide effective services at a reasonable cost makes the relationship approach a practical proposition.

Like any customer/vendor relationship, both parties must profit from the relationship or else it will not last. Treasurers must accept that although it is in the company's interests to negotiate the best possible terms with its bank, the bank must have a reasonable earnings stream from the relationship, or at least the prospect of reasonable earnings in the future. There is an inevitable competitive tension here; both parties need to understand and manage that situation.

Other relevant points included will be considered with appropriate marks being made available.

Syllabus ref: LO 3, 13, 17, 18

Total: 25 marks

Question 2

Triumph Homes Background

Triumph Homes (TH) was founded in 1972 and is today one of the UK's leading housebuilders. It is listed on the London Stock Exchange and is a constituent of the FTSE 100 Index with a current share price of GBP19.16.

With headquarters in Leeds, TH operates from 31 regional offices throughout the UK. It has over 4,900 employees with a significant number of them long serving.

As one of the largest house builders in the UK, TH places great importance on the contribution it makes to the communities it serves. TH continues to deliver strong commercial performance and it appreciates that its success remains dependent on delivery for all of its stakeholders – notably the customers, people, suppliers and Government. TH has stated that it is stepping up efforts to continue to improve customer satisfaction levels with a number of new initiatives being introduced which it believes will bring significant improvements for its customers.

In line with the strategic priorities which seek to maximise cash efficiency and capital discipline through the cycle, TH's liquidity remains strong. TH held GBP1,048.1m of cash at the end of 2019 (2018: GBP1,302.7m).

Financial and strategic overview

TH delivered a very strong performance in 2019, with revenues (noting this includes non-housing revenue as well) increasing by 4% to GBP3,737.6m (2018: GBP3,597.8m) and profit before tax increasing by 13% to GBP1,090.8m (2018: GBP966.1m). It delivered 16,449 new homes to customers across the UK (2018: 16,043), an increase of 406 new homes compared with last year. TH's average selling price of GBP215,563 was 1% higher (2018: GBP213,321). In line with its strategic priorities which seek to maximise cash efficiency and capital discipline through the cycle, TH's liquidity remains strong. It held 1,048.1m of cash at the end of the year (2018: GBP1,302.7m).

TH's long term strategy prioritises the creation and preservation of superior shareholder value through the economic cycle by building good quality homes; providing rewarding careers for employees and giving continuity of business to suppliers.

TH is focused on delivering high quality growth to meet market demand across the UK, investing in land and infrastructure to support further increases in new home construction which local communities need.

TH has continued to reinvest for the future acquiring 17,092 plots of new land across 84 high quality locations through the year, with strategic land holdings contributing 3,772 plots. In the second half of 2019 TH acquired 6,020 plots of new land across 39 locations. Its net land spend of GBP605.1m for the year includes GBP279.3m in the second half which included GBP145.8m of existing land creditor payments. TH's land creditor commitments at 31 December 2019 were GBP548.0m, GBP19.3m lower than the prior year. Return on average capital employed was 52.8% for 2019, slightly ahead of the previous year (2018: 51.5%).

The board remains confident in TH's financial strength and ability to meet its schedule of committed capital return payments.

5 year financial summary

	2019	2018	2017	2016	2015
Unit sales	16,449	16,043	15,171	14,572	13,509
Housing revenue (GBPm)	3,545.8	3,422.3	3,136.8	2,901.7	2,573.9
Average selling price (GBP)	215,563	213,321	206,765	199,127	190,533
Profit from operations (GBPm)	1,091.9	966.1	778.5	634.5	473.3
Profit before tax (GBPm)	1,100.0	977.1	782.8	637.8	475.0
Basic earnings per share (GBP)	2.863	2.586	2.056	1.730	1.245
Diluted earnings per share (GBP)	2.837	2.465	1.995	1.691	1.243
Cash return/dividend per share (GBP)	2.35	2.35	1.35	1.10	0.95
Net assets per share (GBP)	10.060	10.366	8.873	8.007	7.154
Total shareholders' equity (GBPm)	3,194.5	3,201.6	2,737.4	2,455.8	2,192.6
Return on capital employed	52.8%	51.5%	39.4%	32.1%	24.6%

CEO's overview

"Since the launch of our strategy in 2012 we have focused on increasing the strength, resilience, and performance of Triumph Homes for the long term. Building a strong vibrant business where our employees are proud to work, constructing well designed traditional homes and creating sustainable communities throughout the UK remains our central focus."

The board, governance and culture

The board currently comprises seven directors; CEO, two more executive directors with extensive housebuilding experience, balanced by four independent non-executive directors with a diversity of skills and experience to provide sound advice, judgement and constructive challenge to the executive directors.

The Nomination Committee will continue to review succession planning and the composition of the board with regard to the balance of relevant skills, knowledge, experience and independence.

TH's culture is one of hard work with a drive for excellence. Management lead by example and all employees work to achieve high standards in all areas of the business. TH has an entrepreneurial spirit within a structure of centralised control and a meritocratic environment.

TH has complied with the UK Corporate Governance Code 2016 throughout 2018 and 2019. During 2018 / 2019 the board conducted an exercise to prepare for the implementation of the new UK Corporate Governance Code 2018, which included:

- reviewing TH's culture, including how it will be monitored and assessed;
- the establishment of an Employee Engagement Panel in 2019; and
- the establishment of a Gender Diversity Panel to consider how TH can improve its gender diversity. Senior roles are a particular area of focus.

Director remuneration

TH announced that as part of a long-term incentive plan (setup at the end of 2014 when the share price was GBP13.12), that the chief executive will receive a bonus of around GBP100m. The market, analysts

and other stakeholders reacted very negatively to this announcement, especially given the government subsidy of new homes.
TH commented that the amount being paid out could not be changed and was contractual (given target had been met) and signed off by the remuneration panel. TH also stated that it is; "committed to change pay and incentives to include greater emphasis on both quality and customer care with plans that are more rigorous than we have had in the past. We remain focused on making a good contribution to increasing the industry's output of new homes across the UK so that more people gain access to good value, well-designed homes in line with Government policy and targets. We will continue to invest in our own manufacturing capabilities - timber frame construction, brick and tile works - to ensure we are able to support our development programmes over future years."

Q2	(a) Evaluate whether the performance of TH justifies the level of bonuses paid out. (b) Recommend and justify an appropriate remuneration structure that TH could put in place.	10 marks 15 marks
		Total: 25 marks

Q2 answer

(a)
It is first important to note that answers should focus on both financial and non-financial performance of TH, especially given the aims and nature of the company. There should also be a clear answer given to the question i.e. yes it does or no it does not!

Key financial analysis that should be carried out includes looking at the financial performance increase over the LTIP period:

Unit sales	21.76%
Housing revenue	37.76%
Average selling price	13.14%
Profit from operations	130.70%
Profit before tax	131.58%
Basic earnings per share	129.96%
Diluted earnings per share	128.24%
Cash return/dividend per share	147.37%
Net assets per share	40.62%
Total shareholders' equity	45.69%
Return on capital employed	114.63%

From this it is clear that significance shareholder value has been created (i.e. 1bn increase in shareholders' equity, large increases in cash dividends paid out, share price move from GBP13.12 to GBP19.16) and of that 10% has been paid to the CEO.

1 mark per developed point

	Better answers would note that the CEO will not be the only one getting a bonus so further information would be needed to fully understand how much more will be paid in bonuses relative to the value created. Answers should also discuss the investments made by the business in land and developments that could signal further value creation and that value has not just been created from short term decision making. Further analysis should be carried out on the following: • The need for peer & market analysis to benchmark financial / share price performance • The components of the bonus payment • The targets laid out in the LTIP • The number of affordable housing that the company has provided • The financial support received from the government in the help to buy scheme • The role of Triumph in the community • How objective the remuneration committee were in agreeing the terms • Remuneration structures used by TH's peer group Whilst significant shareholder value has been created the level of the bonus payments made seems excessive. Other relevant points included will be considered with appropriate marks being made available. (b) Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose • a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance • there should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. • No director should be involved in deciding his or her own remuneration. • the remuneration structure of managers could be designed so that their interests are aligned to those of shareholders. However, there continues to be debate about what remuneration is linked to. Usually remuneration is linked to: • profits, noting that linking financial rewards to profits may lead to short-termism and creative accounting	1 mark per developed point

- share price via share options, which only vest in several years (to ensure long term decisions are take) and are sufficiently stretching.

Answers could discuss the remuneration code in the UK corporate governance code 2018

- The board should establish a remuneration committee of independent non-executive directors, with a minimum membership of three, or in the case of smaller companies, two.
- In addition, the chair of the board can only be a member if they were independent on appointment and cannot chair the committee. Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.
- The remuneration committee should have delegated responsibility for determining the policy for executive director remuneration and setting remuneration for the chair, executive directors and senior management.
- It should review workforce remuneration and related policies and the alignment of incentives and rewards with culture, taking these into account when setting the policy for executive director remuneration.
- The remuneration of non-executive directors should be determined in accordance with the Articles of Association or, alternatively, by the board. Levels of remuneration for the chair and all non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for all non-executive directors should not include share options or other performance-related elements.
- Where a remuneration consultant is appointed, this should be the responsibility of the remuneration committee. The consultant should be identified in the annual report alongside a statement about any other connection it has with the company or individual directors. Independent judgement should be exercised when evaluating the advice of external third parties and when receiving views from executive directors and senior management.
- Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests. Share awards granted for this purpose should be released for sale on a phased basis and be subject to a total vesting and holding period of five years or more. The remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares.
- Remuneration schemes and policies should enable the use of discretion to override formulaic outcomes. They should also include provisions that would enable the company to recover

and/or withhold sums or share awards and specify the circumstances in which it would be appropriate to do so.

- Only basic salary should be pensionable. The pension contribution rates for executive directors, or payments in lieu, should be aligned with those available to the workforce. The pension consequences and associated costs of basic salary increases and any other changes in pensionable remuneration, or contribution rates, particularly for directors close to retirement, should be carefully considered when compared with workforce arrangements.
- Notice or contract periods should be one year or less. If it is necessary to offer longer periods to new directors recruited from outside the company, such periods should reduce to one year or less after the initial period. The remuneration committee should ensure compensation commitments in directors' terms of appointment do not reward poor performance. They should be robust in reducing compensation to reflect departing directors' obligations to mitigate loss.

When determining executive director remuneration policy and practices, the remuneration committee should address the following:

- clarity – remuneration arrangements should be transparent and promote effective engagement with shareholders and the workforce;
- simplicity – remuneration structures should avoid complexity and their rationale and operation should be easy to understand;
- risk – remuneration arrangements should ensure reputational and other risks from excessive rewards, and behavioural risks that can arise from target-based incentive plans, are identified and mitigated;
- predictability–the range of possible values of rewards to individual directors and any other limits or discretions should be identified and explained at the time of approving the policy;
- proportionality – the link between individual awards, the delivery of strategy and the long-term performance of the company should be clear. Outcomes should not reward poor performance; and
- alignment to culture–incentive schemes should drive behaviours consistent with company purpose, values and strategy.

There should be a description of the work of the remuneration committee in the annual report, including:

- an explanation of the strategic rationale for executive directors' remuneration policies, structures and any performance metrics;

- reasons why the remuneration is appropriate using internal and external measures, including pay ratios and pay gaps;
- a description, with examples, of how the remuneration committee has addressed the factors in Provision 40;
- whether the remuneration policy operated as intended in terms of company performance and quantum, and, if not, what changes are necessary;
- what engagement has taken place with shareholders and the impact this has had on remuneration policy and outcomes;
- what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company pay policy; and
- to what extent discretion has been applied to remuneration outcomes and the reasons why.

Best practice considerations that should be applied when setting director remuneration:

- **Consider the value of director services provided** – where remuneration is not calculated by reference to the value of the services provided by directors who are in control of the company and is instead a disguised payment of dividend or dressed-up return of capital this is likely to constitute unfairly prejudicial conduct even where approved by the shareholders in a general meeting.
- **Consider director remuneration alongside the trading condition of the company** – where remuneration is a genuine reward for service, but can be objectively shown to be excessive in the light of expert evidence on comparable remuneration or the trading conditions of the company, a decision of the board of directors to approve that remuneration may be found to have been taken in breach of fiduciary duty for the improper purposes of self-enrichment.
- **Be transparent** – if director remuneration could be seen as a guise for the return of capital, document all considerations through employment documentation and/or reviews.
- **Ensure that board approval has been obtained** – where remuneration has not been approved by the board of directors, shareholders or otherwise in accordance with the articles of association, it is for the court to determine whether the amounts drawn were appropriate. This is a question of fact appraised by reference to whether or not the remuneration is within the bracket that executives carrying the sort of responsibility and discharging the sort of duties that the director in question would expect to receive.
- **Document decision making** – where a director is so critical to the survival of a company and its business that paying remuneration in excess of what is considered within the normal range is

	justifiable, ensure that this is documented and kept in the company records. • **Apply objective commercial criteria when assessing a directors' remuneration** – the Court has stated that one must consider whether the remuneration that is provided is within the bracket that executives, carrying the responsibility and discharging the sort of duties of the respondent, would expect to receive. Other relevant points included will be considered with appropriate marks being made available. **Syllabus ref:** LO 1,2 3, 17, 18	
		Total: 25 marks

Question 3

Relentless Sports background

You are the newly appointed treasurer at Relentless Sports (RS).

RS is a unique fashion brand that is focused on clothing for climbing and adventurers. Over the last few years its brand has gained traction in the mainstream and sales have grown and new market opportunities have arisen. It designs, manufactures and sells all of its products in a sustainable way. RS does not use outsourcing for any of these activities.

Despite some of the malaise in high street retailing, RS has begun to investigate opening stores in global retail centres such as London, Paris, New York. In order to fund this expansion, RS are investigating several options, alongside meeting existing shareholder and covenant requirements.

Summary financials (GBPm)

Fixed assets:	
Land and Buildings	50
Plant & machinery	180
Current assets:	
Inventory	42
Receivables	70
Cash	126
Total Assets	**468**
Current liabilities:	
Bank overdraft	20
Trade payables	34
Long term liabilities	
Bank term loan	110
Total Liabilities	**164**
Ordinary shares (GBP1 par value)	120
Retained earnings	184
Total Equity	**304**
Total Liabilities & Equity	**468**
P&L Extracts	
Operating profit	112
Interest paid	6.5
Corporation Tax rate	20%

RS follows a policy of maintaining a constant dividend per share of GBP0.35.

Funding options and constraints

In order to execute its global expansion strategy, RS needs to raise around GBP120m that is expected to result in a 5% increase in the level of operating profit in year one, noting larger increases are expected in future years as stores become established.

The board is split on the best way to proceed and two options have been shortlisted

Option one – Share issuance at a price of GBP4 via a placing with an investment fund that will have a subsequent impact upon earnings per share (EPS) and the voting rights of existing shareholders.

Option two - To expand the current bank overdraft line as the additional borrowing could potentially be paid down again in a few years. It is expected that the interest rate payable on any new funding will be the same as the RS's current rate.

RS's existing borrowings include the following covenants:

1. Current ratio to be at least 1:1.
2. Ratio of debt to equity not to exceed 0.5:1.
3. Interest cover of at least 10 times to be maintained at all times.
4. Dividend pay-out ratio not to exceed 50 percent.

The bank is insisting that the same covenants must apply to any new borrowing as well.

Financial covenant compliance is measured annually.

Q3	(a) Evaluate the impact of the two financing proposals on RS's ability to comply with its covenants.	10 marks
	(b) Critically evaluate the relative merits of the two financing proposals and within your answer you are required to recommend and justify which financing option RS should pursue.	7 marks
	(c) Discuss why the bank is likely to be insisting on the four covenants outlined in the case study and why you as treasurer might be averse to agreeing to them.	8 marks
		Total: 25 marks

Q3 answer

(a)

	Base (GBPm)	Equity (GBPm)	Debt (GBPm)
Operating profit	112	117.6	117.6
Interest paid	6.5	6.5	12.5
Corporation Tax rate	20%	20%	20%

Net Income	84.4	88.88	84.08
Total dividends	42	52.5	42
Retained Earnings	**184**	**220.38**	**226.08**

4 marks for the calculations for each financing option and then 1 mark per developed

Current ratio	**4.41**	**4.41**	**1.37**
Debt/Equity	**42.76%**	**28.24%**	**72.24%**
Interest cover	**17.23**	**18.09**	**9.41**
Dividend pay-out	**49.76%**	**59.07%**	**49.95%**

point for the analysis

Key points should include

- The use of an overdraft would result in 3 covenant breaches.
- The equity financing would see the dividend covenant breached.
- These figures are based on several assumptions such as that all funds raised would be used in fixed assets and also noting that OP is based only on year 1 when after year 1 it is likely that OP will increase significantly more.

Other relevant points included will be considered with appropriate marks being made available.

(b) Key points include

- The debt financing structure is evidently not viable given the covenant breaches that would occur.
- Whilst it might be better longer term as debt can be paid down with no dilution issues the covenant breaches are significant.
- Better answers might discuss how the company could negotiate on the covenants and even agree a 1 year carve out.
- The placing is not ideal as it will dilute existing shareholders and give a large holding to one party that could result in takeover issues or control issues.
- EPS would decline under the share issues and place more pressure on dividends.
- Given the dividend covenant breach, dividends will have to be reduced for 1 year to 29.62p. This is a small reduction and might be accepted by shareholders as a one off.
- Better answers could also discuss how using a debt/equity mix might be a better option.

1 mark per developed point

Other relevant points included will be considered with appropriate marks being made available.

(c) Bank insistence and treasurer viewpoints on the four covenants;
Current ratio

- Puts in place protection against overtrading and the short-term liquidity position of the business. This is crucial for lending to ensure interest payments and capital is met as expected. Also, it protects against bankruptcy. Care needs to be taken though given some retailers are wholly liquid despite having a current ratio of below 1.
- It might lead to RS having to take a more conservative Working capital approach, lead to using longer term rather than shorter term financing and impact upon their desired level of holding

1 mark per developed point

stock and cash (the former being not that liquid potentially in a downturn).

Debt/Equity

- Prevents the borrower taking on too much debt and increasing the likely / cost of default. Limits how much debt can be issued against the net worth of the business. Key aim is to limit the amount of borrowing and protect the interests of the lender.
- Such a covenant limits the amount of capital (debt) Relentless can issue and also might result in a sub-optimal capital structure.

Interest cover

- Put in place to ensure that Relentless maintains an adequate level of cover in meeting its interest liabilities. Note that in practice EBITDA is more likely to be used that the traditional OP/Interest formula.
- Like in the D/E rationale it limits the amount of debt and also places pressure on the accounting process of reporting operating profit (which is not a cash measure). It also puts great pressure on RS to protect against any short term profit dips.

Dividend cover

- Ensure profits are retained in the interests of debt holders rather than paid out to shareholders. This provides future protection against downturns and ensures cash does not depart from the business to shareholders.
- A short term dip in profits could result in dividends being cut which impacts the share price, and management credibility. This might then make it difficult to raise additional funds in the market. Also, if peers raise their dividend, RS cannot respond.

Other relevant points included will be considered with appropriate marks being made available.

Syllabus ref: LO 9, 10, 11, 13, 19

Total: 25 marks

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