

Pulling the right levers



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Targeting a level of balance sheet leverage is a core strategic decision and managing it successfully has a significant impact on the level of shareholder returns. This article describes how the multinational corporate, operating and earning money in many different currencies can efficiently manage the effects of foreign exchange movements on its balance sheet leverage. For the purposes of this discussion we will define balance sheet leverage as net debt to EBITDA as this ratio is fundamental in credit rating agency and lender analysis. Successfully managing the leverage ratio contributes towards these areas;

- Credit strength and the ensuing cost and availability of borrowing
- Compliance with lender covenants
- The cost of equity through optimising WACC and increasing the stability of earnings
- Support for long term client and supplier relationships
- Instilling investor confidence in management

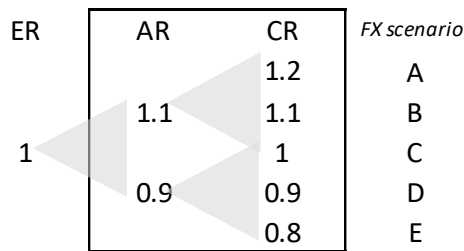
The approach many corporates take is to borrow against future cash flows or earnings (often EBITDA) particularly where the business is asset light in nature and shareholder value is more closely linked to cash flow generation. Traditionally the effective currency of debt has been aligned in direct proportion to the levels of earnings or cash. Translation risk to the leverage ratio poses an interesting problem because cash flows or earnings are translated at the average exchange rate for the period, whereas debt is translated at closing rate. The different exchange rates used to translate the two inputs into the leverage ratio can cause variations in the ratio even if levels of currency debt and EBITDA are delivered exactly to target. And the reason is very simple; the average exchange rate used for cash flow earnings translation is significantly less volatile within an annual reporting cycle than the closing exchange rate used to translate foreign currency denominated debt.

The typical formulation of an overall leverage target will see the corporate plan for an appropriate level of CAPEX, M&A and dividends in conjunction with its forecast operating cash flows and EBITDA. Delivery of this plan is beyond the scope of this discussion. What we examine here is the ability of the corporate to minimise the effect of translation upon the reported leverage ratio by adjusting the effective currency of the debt portfolio. The exposure we are managing in this situation is the impact arising from the average and closing exchange rates being different from the expected exchange rate when the cash flow plan and the closing leverage target for the year ahead were determined. In the usual financial cycle this would be a spot¹ rate around the time that the annual budget or longer-term business plan is finalised. In figure one we refer to this as the expected rate.

¹ Or more precisely the forward rate.

Figure one; FX effect on leverage ratio

Base case	Value
EBITDA	1,000
Target closing debt	1,000
Target leverage ratio	1



Evolution of exchange rates¹

¹ ER = expected rate, AR = average rate, CR = closing rate

Figure one sets up a model which assumes all the corporate's earning are in foreign currency. The expected exchange rate is one. Using this rate both EBITDA and target closing debt translate into a reported value of 1,000 giving a leverage ratio of 1. Figure one also sets up a crude model of the real world by showing exchange rates moving away from the expected rate by an increment of 10% every 6 months. This results in an average exchange rate of between 0.9-1.1 of the expected rate and a closing exchange rate within a range of 0.8-1.2.

Figure two; portfolio 1 has 100% debt denominated in foreign currency

EBITDA	1,000
Ccy debt	1,000
Functional currency debt	<u>0</u>
Target closing debt	1,000
Target leverage ratio	1

EBITDA result	Debt result		Leverag ratio	Delta
	833	A	0.92	0.08
909	909	B	1.00	0.00
	1,000	C	1.1/0.9	0.10
1,111	1,111	D	1.00	0.00
	1,250	E	1.13	0.13

Total absolute delta 0.41

Figure two shows what happens when debt portfolio one is tested through changing FX rates introduced in figure one. Remember the effective currency of debt is aligned on a one to one basis to the currency of EBITDA. Figure three shows the equivalent for a debt portfolio where only half of the debt is denominated in the foreign currency in which EBITDA is earned. The other half is retained in the functional currency of the reporting entity.

Figure three; portfolio 2 has 50% debt denominated in foreign currency & 50% in

EBITDA	1,000
Ccy debt	500
Functional currency debt	<u>500</u>
Target closing debt	1,000
Target leverage ratio	1

EBITDA result	Debt result		Leverag ratio	Delta
	917	A	1.01	0.01
909	955	B	1.05	0.05
	1,000	C	1.1/0.9	0.10
1,111	1,056	D	0.95	0.05
	1,125	E	1.01	0.01

Absolute delta 0.32

Both portfolios produce the target leverage ratio of "1" if exchange rates do not change from the expected rate at the start of the year. Reported EBITDA is the same in both figures two and three, however the level of reported debt turns out differently given the same closing exchange rate as the mix of currency debt is different in figures two and three. Comparing the resulting leverage ratios shows that;

- Figure three produces a tighter range of leverage outcomes around the target (absolute delta of 0.32 versus 0.41)
- Figure three also produces less extreme results; 0.9 and 1.1 versus 0.9 and 1.13

Holding only half of the debt portfolio in the same currency that the corporate's earnings are denominated in as shown in figure three, produces a lower translation risk to the leverage ratio². Matching the currency of earnings to debt in the same proportions (figure two) introduces more risk into the ratio.

Clearly across the infinite range of exchange rate scenarios that can play out over the course of a reporting period alternative debt portfolios will under or over perform versus others. However, the approach discussed allows the corporate to carry out a meaningful analysis of translation risk to its balance sheet leverage. The corporate can now consider this alongside other factors such as the interest cost resulting from different mixes of currency within its debt portfolio. Understanding the risk and the tools available to manage it allows management to make informed decisions which over time should produce a more stable and targeted reported leverage ratio and benefit the creation of shareholder value.

² As long as the residual is held in the functional currency of the reporting entity!