# TPE MAY 2023 – Guide to Answer

## Mock 3 – Quaerum

*The Test of Professional Expertise multi-discipline case study is designed to encourage students to provide alternative creative answers and there is no "right answer" at TPE level. This Guide to Answer illustrates the structure and the depth of analysis and explanation the examiners are seeking.*

*In assessing candidates' scripts, credit is always given for appropriate answers even if not contained in this published guide.*

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**Notes to students:** this guide contains a number of tables which were copied from the question paper. These were included to assist markers, and students were NOT expected to include these. No marks were available for including these.

## 1. BRIEFING PAPER FOR EMMA REID

1. Prepare the briefing paper for Emma on the review of QI's funds; and
2. The potential addition of Blackstuff to the All Commodities Fund and Energy Fund.

### *Introduction*

This briefing paper does the following:

- Reviews QI's funds to identify potential opportunities to improve performance and risk exposure
- Appraises the potential investment in Blackstuff.

### *1. Review of funds*

#### *1.1. Overview*

QI operates five funds. Key information about their performance in Yr21 is summarised in Table 1.

**Table 1: Summary of fund performance (Yr21)**

| **Fund** | **Fund size £m** | **RoI %** | **Benchmark RoI %** |
|---|---|---|---|
| All Commodities Fund | 195 | 20 | 12 |
| Energy | 35 | 14 | 14 |
| Metals | 23 | 32 | 8 |
| Livestock | 14 | 12 | 8 |
| Agriculture | 18 | 22 | 18 |
| | | | |
| **Totals** | **285** | | **12** |

As can be seen from Table 1, in Year 21, fund performance ranged from 12% to 32% and all funds matched or outperformed benchmarks. Performance ranged from the Energy Fund which matched its benchmark to the Metals Fund which outperformed the benchmark by 300% (32% vs 8%).

All Commodities Fund is equally invested in each of the four commodity sectors. On the basis of the Yr21 figures alone, it looks as if there is scope to rebalance All Commodities Fund so that it invests proportionately more in the better performing sectors such as Metals. However, a single year's figures are not enough on which to base that rebalancing. It is also important to look at past performance and on future prospects for each class of commodity too.

Information is not available for the past performance of each fund, but it is available for All Commodities Fund (see Table 2). Over the five years from Yr17-Yr21 inclusive, it can be seen that the RoI has outperformed the benchmark by over a third (13.4% vs 10%). Clearly, All Commodities Fund is a successful fund but the question remains whether it can be even more profitable by rebalancing its composition.

**Table 2: All Commodities Fund performance Yr17-Yr21**

| | Yr17 | Yr18 | Yr19 | Yr20 | Yr21 | Mean |
|---|---|---|---|---|---|---|
| Fund size (£m) | 130 | 150 | 155 | 180 | 195 | 162 |
| RoI (%) | 17 | 4 | 15 | 11 | 20 | 13.4 |
| AIM benchmark RoI (%) | 10 | 6 | 10 | 12 | 12 | 10 |
| Variation from benchmark (%) | 7 | (2) | 5 | (1) | 8 | 3.4 |

Looking at the performance of each fund and prospects for each of the commodity sectors suggests that, subject to further analysis, there is scope to increase the performance of All Commodities Fund.

## 1.2. Energy Fund

**Table 3: Energy Fund composition**

| Company | Type | Operational Area | % of fund | % RoI (Year 21) |
|---|---|---|---|---|
| Asian Energy | Gas | South East Asia | 25 | 28 |
| Guinea Group (Oil) | Oil | West Africa | 25 | **6** |
| Hydro Sun | Renewables | China | 10 | 15 |
| Nigeria Premium plc | Oil | West Africa | 20 | **8** |
| Turbo Turbine plc | Renewables | Europe | 10 | **4** |
| Western States Group (Oil) | Oil | North America | 10 | 20 |
| | | | | |
| **Totals** | | | 100 | 14 |

Based on market assessments, it appears likely that energy investments will reduce in value over the next decade. Although demand is likely to increase in line with GDP, the demand for renewable energy is growing and in the second half of the decade, alternatives to oil and gas will become much more prominent. This suggests that QI should be seeking to increase its investments in renewables as a proportion of the fund.

Currently, in overall terms, QI's Energy Fund performs in line with benchmarked funds (14%) but 55% of the fund (Guinea Oil, Nigeria Premium plc, Turbo Turbine plc) is failing to meet the benchmark. QI aims to deliver an RoI of at least 10% pa over a five-year period. The same 55% is failing to meet that target based on the Yr21 figures.

Only 20% of the fund is invested in renewables and half of the renewables investment is not achieving the target returns.

The fund has been volatile in recent years and so annual returns from 2016 should be examined to see if the Yr21 position is typical and investments that do not meet the financial targets should be sold. This would allow QI to invest in more profitable businesses.

Based on the market assessment, QI should be seeking investment opportunities in alternative energy companies. In particular, QI should be seeking to disinvest in oil, which currently comprises 55% of the fund and carries an additional risk in that 45% of fund investments are in West Africa.

### 1.3. Metals Fund

Although the fund's performance exceeded QI's target 10% return in Yr21 and the benchmark of 8% by a substantial margin, the returns on gold are significantly less than the returns on other metals. One of the companies (25% of the fund) did not achieve QI's target return of 10%. 45% of the fund (two companies) is in gold in West Africa and so QI is exposed to geographic risk as well as risks associated with the demand for gold.

**Table 4: Metals Fund composition**

| Company | Type | Operational Area | % of fund | % RoI (Year 21) |
|---|---|---|---|---|
| Guinea Group (Gold) | Gold | West Africa | 25 | **8** |
| Electro-copper plc | Copper - Renewables | South America | 10 | 42 |
| Modern Tech Ideas | Platinum | North America | 10 | 22 |
| Rare Minerals | Various | China | 15 | 80 |
| Polymetal plc | Copper | South East Asia | 20 | 46 |
| Coastal Capital | Gold | West Africa | 20 | 12 |
| | | | | |
| **Totals** | | | 100 | 32 |

Market assessments suggest a positive outlook for metals but parts of West Africa and South America have risks to productivity associated with industrial relations. This suggests that QI should review its investments in West Africa and South America to try and quantify the risk to its Metals Fund. Currently most of the fund is invested in West Africa and South America.

Platinum mining has reduced in the last five years due to a lack of cost-effective mining opportunities. 10% of the fund is invested in platinum and generated a 22% return in Yr21. Provided the company is able to control extraction costs, then this remains an attractive investment. In addition, due to the developments in battery technology, QI should consider expanding the use of copper and expanding further into Lithium.

Although the gold investments did not perform as well as the other metals in Yr21, it remains an important hedge and so QI should continue to invest in gold. However, the point about geographic risk remains and QI should consider shifting some of its investments into gold in other geographic areas.

### 1.4. Livestock fund

Although the fund performed better than the benchmark, 25% of the investments (Midwest Operations) sustained a negative return and 25% of the investments (Premium Pork) did not achieve QI's target 10% return for investors. Further information is required to be able to assess whether these companies met this target over a longer period and whether they are likely to perform above the target return level in future.

**Table 5: Livestock fund composition**

| Company | Type | Operational Area | % of fund | % RoI (*Yr21*) |
|---|---|---|---|---|
| Western States Group (Beef) | Beef | North America | 20 | 10 |
| Premium Pork | Pig | North America | 25 | **8** |
| Yunnan Foods | Pig | China | 10 | 31 |
| Midwest Operations plc | Mixed | North America | 25 | **-2** |
| Healthy Free Farms | Beef | Europe | 10 | 29 |
| Freedom Livestock | Oxen | South America | 10 | 25 |
| | | | | |
| **Totals** | | | 100 | 12 |

The outlook for demand in developing countries is positive and is likely to exceed that of developed countries where there is a trend towards less meat consumption, especially beef.

At least 30% of the fund is invested in beef and so QI should consider reducing its beef investments and increasing its investments in pig or Oxen, which achieved the highest return in Yr21.

70% of the fund is invested in North America. This creates a geographic risk and should be mitigated. The two underperforming companies mentioned earlier are based in North America. (see 1.6 for further discussion of geographical risk)

## 1.5. Agriculture fund

Most investments met the QI target in Year 21 and the fund, as a whole, performed better than the benchmark of 18%. However, 25% of the fund did not (Western States Group (Corn)).

There is a strong link between grain prices in the agricultural sector and livestock prices. That might explain why the North American investments in both the Agriculture and the Livestock Funds are performing less well than the others ie they are both affected by particular circumstances in the North American economy around beef. And the good performance of the Chinese investments in Livestock and Agriculture support this.

This reinforces the recommendation in the previous section that QI should mitigate its North American risks. Investing more in China appears to be worth exploring.

**Table 6: Agriculture Fund composition**

| Company | Type | Operational Area | % of fund | % RoI (*Yr21*) |
|---|---|---|---|---|
| Cocoa co-operative | Cocoa | West Africa | 10 | 42 |
| Design Clothing | Cotton | South East Asia | 10 | 25 |
| Best Rice | Grains | China | 15 | 48 |
| Guinea Group (Coffee) | Coffee | West Africa | 25 | 10 |
| Animal Feeds | Grains | South America | 15 | 24 |
| Western States Group (Corn) | Grains | North America | 25 | 8 |
| | | | | |
| **Totals** | | | 100 | 22 |

Demand for coffee is likely to grow ahead of GDP and the most efficient producers tend to be in South America. QI should consider increasing its investment in this area and product.

Conversely, 35% of the fund is invested in West Africa but agriculture yields in developing countries are particularly at risk of weather-related events leading to under or over supply. This risk should be mitigated, potentially by investing less in West Africa.

### *1.6. Geographic risk: West Africa (1 mark)*

A recurring theme throughout this review has been the exposure of QI to West African investments (see Table 7). More than a third of all investments (£65.81m) in All Commodities Fund are in West Africa. This should be mitigated as a matter of urgency through increasing the geographical diversity of investments held.

**Table 7: All Commodities Fund exposure to West African investments**

| Fund | Fund size £m | West Africa % | West Africa £m |
|---|---|---|---|
| All Commodities Fund | 195 | 34 | 65.81 |
| Energy | 48.75 | 45 | 21.94 |
| Metals | 48.75 | 45 | 21.94 |
| Livestock | 48.75 | 0 | 0 |
| Agriculture | 48.75 | 35 | 17.06 |

### *1.7. Company (overall) risk*

QI is likely to be over-exposed to investments in the Guinea group and the Western States group (see Table 8 – principle also applies to all 5 funds). Just under a third of all investments (£63.39m) in All Commodities Fund are in Guinea and Western States companies. This should be mitigated as a matter of urgency by reducing the proportion invested in these companies.

**Table 8: All Commodities Fund exposure to Guinea and Western States group investments**

| Fund | Fund size £m | Guinea group % | Guinea group £m | Western States group % | Western States group £m |
|---|---|---|---|---|---|
| All Commodities Fund | 195 | 18.8 | 36.57 | 13.8 | 26.82 |
| Energy | 48.75 | 25 | 12.19 | 10 | 4.88 |
| Metals | 48.75 | 25 | 12.19 | 0 | 0 |
| Livestock | 48.75 | 0 | 0 | 20 | 9.75 |
| Agriculture | 48.75 | 25 | 12.19 | 25 | 12.19 |

## 2. Blackstuff PLC

### 1. Introduction and background

Using information provided by the analyst team, Blackstuff plc has been appraised as a potential investment opportunity. It must be noted that while the assessment has been based on the best available information, there remains a risk that this information is incomplete.

Some background information is provided before financial and non-financial considerations are assessed. References are made to the strategic report and CSR disclosures in Blackstuff's latest audited annual report. Financial information has also been extracted from audited financial statements for each of the previous five years. The detailed financial analysis is set out in Appendix A.

### 2. Performance

### 2.1. Oil profitability and demand

Information in the extracts from the latest annual report includes a projected increase in the key metric of operating profit per barrel of 2% a year for the next five years due to reductions in operating costs. The company is forecasting a stable operating environment and predictable future product demand.

While this appears positive, our own analysis suggests that the demand for oil is expected to decline in the second half of the next decade, therefore it is unlikely that future product demand will continue to increase.

Other metrics suggest that Blackstuff's operating profit per barrel is considerably higher than the industry average (£20 versus £15). This could be due to a lack of capital investment which is 60% of the industry average. This would have the effect of reducing depreciation and financing charges.

### 2.2. Investment and maintenance

The reduction in capital investment could be correlated with higher-than-average maintenance costs (24% versus the industry average of 14%). And worryingly, the lack of investment could be at the root of the higher-than-average number of serious injuries or fatalities (11 versus 3).

Efficiency has also been affected with drill downtime increasing to 40 days compared to 21 days, five years ago.

The share price is largely based on confidence in the level of oil reserves available to Blackstuff. $(\frac{1}{2})$ The external auditors considered the valuation of these reserves as a key audit matter and it is apparent that there is a significant level of risk associated with the valuation of these reserves. 75% of the reserves (21m of 28m barrels) by volume are classified as 'probable' i.e. available with only a 50% degree of certainty.

The company claims to have a high drilling success rate of 75% for new prospects. This is a positive indicator of future profitability.

However, future revenue is dependent upon having the appropriate drilling operating licences. The annual report notes that the renewal of the licences has been delayed due to minor maintenance matters and poor weather conditions. It is unlikely that poor weather conditions have existed for nine months. There is a risk therefore that the licences could be delayed longer than anticipated and/or lack of maintenance could be contributing to the poor safety record.

### 2.3. Leadership

The company seeks to be debt free within ten years and its modest increase in executive remuneration (2%) could be interpreted as a prudent approach to costs.

Governance data shows that the percentage of female directors has reduced during the year to well below 50% (now 20%) and that there has been a reduction in audit committee attendance from 80% to 70%. It is not possible to draw conclusions from this data alone, but there has been significant turnover at board level (4 of 5 posts within the last 6 months), and it would be worth finding out more about this.

With all of the executive leadership team joining the company within six months of the year-end, this suggests that there could have been a major rift within the board during the year, perhaps between the chief executive and the former directors. This might be indicative of an unhealthy culture or it could be a sign that the Chief Executive Officer’s leadership is not effective. However, the annual report claims that the team now has market-leading skills and this could be a positive sign that the leadership team will now progress the strategy more effectively. In either case, the new team is likely to take time to work together effectively and this could have a negative impact on the delivery of business objectives.

The company states a commitment to sustainability in its annual report; however, this is contradicted by the poor health and safety performance. There is no mention in the report of how Blackstuff has invested in its capitals during the year other than a reference to them winning ‘the prestigious ‘Super Staff Relations’ award in Yr21’.

### 2.4. Comparison with investment criteria

QI has investment criteria which apply to all investments. Although Blackstuff appears to be a good prospect for investment based on the financial criteria, other criteria are less positive (see table 9). Overall Blackstuff does not meet the QI investment criteria.

**Table 9: Comparison of Blackstuff to investment criteria**

**Note:** further evaluation of the investment criteria is included within sections 2.1-2.3, therefore credit can be awarded in either area.

| QI Investment Criteria | | Blackstuff |
|---|---|---|
| 1 | Return on capital employed over last 5 years of at least 10% a year on average, excluding the distribution of dividends | Yes, 17.8% simple average over last 5 years (see Table 10) |
| 2 | Return on capital employed over the last 5 years at least in line with their sector average | Yes, 17.8% simple average over last 5 years vs 11.6% for Energy sector as a whole. |
| 3 | Debt as a proportion of capital employed (latest year) does not exceed the sector average | Yes, 63% latest Debt/CE figure for Blackstuff (Table 10) vs 80% sector average. |
| 4 | Current liquidity ratio (latest year) exceeds 1 | Yes =1.02. |
| 5 | Latest stock market valuation is considered by QI to be attractive | Yes. Market value £52.5m vs Net Asset Value £62.4m (Table 10) |
| 6 | Offer the best potential durable growth opportunities for the future | Unlikely because of the forecast drop in demand for oil. There are also some concerns about Blackstuff's lack of capital investment which could indicate a short-term approach to performance. |
| 7 | Resilient to change, particularly technological innovation | There is no information to support this. |
| 8 | Well run and not exposed to significant levels of commodity or country risk | Governance has recently changed, however there are serious health & safety concerns. |
| 9 | Governance practices are in line with leading companies in their sector | No. Gender diversity is low at director level. |
| 10 | Comply fully with local Health & Safety legislation and whose safety record for serious injuries and fatalities is below the industry average | No. They have a poor health and safety record. |
| 11 | Able to evidence continual improvement against environmental standards | No. There is no information in the annual report to support this. |
| 12 | Each QI fund, will invest in a diverse portfolio of equities on a global basis | No, see section 4. |

A summary of key financial information and some relevant ratio analyses are shown in Table 11 (as extracted from Appendix A).

**Table 10: Key financial information**

| | Yr17 | Yr18 | Yr19 | Yr20 | Yr21 |
|---|---|---|---|---|---|
| | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| | | | | | |
| EBITDA (£000) | 25,000 | 36,500 | 16,500 | 26,000 | 45,000 |
| Net profit (£000) | 6,300 | 12,000 | 1,800 | 6,900 | 19,200 |
| Net assets (£000) | 33,000 | 41,500 | 43,300 | 48,800 | 62,400 |
| Capital Employed (£000) | 164,000 | 187,000 | 167,300 | 154,800 | 167,100 |
| Return on Capital Employed | 15% | 20% | 10% | 17% | 27% |
| Debt/Capital employed | 80% | 78% | 74% | 68% | 63% |
| Net assets (NAV) (£000) | 33,000 | 41,500 | 43,300 | 48,800 | 62,400 |
| Market value of company (£000) | 37,500 | 50,000 | 35,000 | 42,000 | 52,500 |
| Market value of company/NAV (£000) | 1.14 | 1.2 | 0.81 | 0.86 | 0.84 |
| Liquidity ratio | 0.89 | 0.56 | 0.29 | 0.61 | 1.02 |

## 2.5. Implications for Energy Fund and All Commodities Fund

QI's Energy Fund has been established for two decades and although it has performed well, it is volatile, meaning that investors have made losses as well as gains. As discussed in section b) 2 of this briefing note, the outlook for energy investment is mixed, with traditional energy sources likely to reduce in value over the next decade but growth opportunities likely to be in alternative energy sources.

The sale of Asian Energy gives QI an opportunity to diversify the Energy Fund by investing more in alternative and sustainable energy sources. Using the cash released by the sale would simply substitute one traditional energy source (gas) for another (oil) and would increase the fund's risk exposure to oil and to West Africa: oil would comprise 80% of the fund and 70% of the fund would be invested in West Africa.

There would of course be a similar increase in risk exposure in All Commodities Fund because it invests in the same equities as the individual funds.

Although Blackstuff seems to offer short-term financial returns that meet QI's investment criteria, it falls considerably short in corporate social responsibility criteria, which is an important aspect of QI's investment strategy.

## 2.6. Conclusions on Blackstuff

In conclusion, although the current financial performance of Blackstuff is positive, there are concerns about its ability to sustain this performance in the future. Declining demand for oil suggests that Blackstuff will not be able to sustain its current performance. The company seems to be very focussed on keeping costs down which suggests that it may be prioritising short-term gains over longer term viability.

The future performance of Blackstuff appears to be based on continuing underinvestment in capital, which keeps down costs but jeopardises lives, and the conversion of probable oil reserves into discovered reserves. There is of course an estimation risk that the conversion assumptions might be too optimistic.

Blackstuff fails to meet QI's criteria relating to CSR. Despite positive comments about CSR in extracts from its annual report, there is little evidence of genuine commitment. It is possible that there may be compelling evidence of commitment to CSR in the full report which has not been assessed, however.

Futhermore, the Energy Fund and All Commodities Fund are already significantly exposed to oil companies operating in West Africa and Blackstuff would exacerbate this exposure.

It is **recommended** that QI should:

- Rebalance All Commodities Fund regularly to benefit from higher performing commodity sectors instead of investing evenly across all four sectors
- Increase investment in alternative and sustainable energy in the Energy Fund
- Reduce exposure to West Africa, the Guinea group and the Western States group across all funds
- Not invest in Blackstuff because it does not meet All Commodities Fund's investment criteria and would expose the Energy Fund and All Commodities Fund to unacceptable risks.

**Appendix A**

**Analysis of Blackstuff plc (from latest annual accounts)**

*Copied from AM paper – no credit awarded for this – included for marker reference.*

| | Yr17 | Yr18 | Yr19 | Yr20 | Yr21 |
|---|---|---|---|---|---|
| **Blackstuff plc** | **£'000** | **£'000** | **£'000** | **£'000** | **£'000** |
| **Comprehensive Income and Expenditure Statement** | | | | | |
| Revenue | 67,000 | 87,000 | 61,000 | 71,000 | 95,500 |
| Cost of generating revenue | 42,000 | 50,500 | 44,500 | 45,000 | 50,500 |
| EBITDA | 25,000 | 36,500 | 16,500 | 26,000 | 45,000 |
| Interest paid | 12,000 | 13,000 | 11,000 | 9,900 | 9,500 |
| Depreciation | 2,500 | 3,500 | 2,500 | 4,600 | 3,500 |
| Tax paid | 4,200 | 8,000 | 1,200 | 4,600 | 12,800 |
| Net profit | 6,300 | 12,000 | 1,800 | 6,900 | 19,200 |
| **Statement of Financial Position** | | | | | |
| Non-Current Assets | 165,000 | 192,500 | 176,000 | 158,700 | 166,900 |
| Non-Current Liabilities (Debt) | 131,000 | 145,500 | 124,000 | 106,000 | 104,700 |
| Current Liabilities | 9,500 | 12,500 | 12,200 | 10,100 | 8,900 |
| Current Assets | 8,500 | 7,000 | 3,500 | 6,200 | 9,100 |
| Net assets | 33,000 | 41,500 | 43,300 | 48,800 | 62,400 |
| Capital Employed = Assets-CL | 164,000 | 187,000 | 167,300 | 154,800 | 167,100 |
| Return on Capital Employed | 15% | 20% | 10% | 17% | 27% |
| Debt/Capital employed | 80% | 78% | 74% | 68% | 63% |
| Net assets= PY BS +net profit CY-dividends paid | 33,000 | 41,500 | 43,300 | 48,800 | 62,400 |

| | | | | | |
|---|---|---|---|---|---|
| **Equity information** | | | | | |
| Share price (pence) | 75 | 100 | 50 | 60 | 75 |
| Number of shares in issue | 50m | 50m | 70m | 70m | 70m |
| Market value of company | 38,000 | 50,000 | 35,000 | 42,000 | 52,500 |
| | | | | | |
| **Other information** | | | | | |
| Cash and Bank balance (year end) | 2,750 | 1,250 | -500 | 750 | 1,500 |
| Dividends paid (pence) | 4 | 7 | 0 | 2 | 8 |
| Dividends paid (total) | 2,000 | 3,500 | 0 | 1,400 | 5,600 |

## 3. REPORT TO THE BOARD FROM TOM LAWSON, CEO

Prepare the draft report to the board on the Blackstuff situation, the implications for the All Commodities Fund and Energy Funds as well as implications for QI's stakeholders. Include your conclusions on the potential benefits for investment decisions of using integrated reports. Make suggestions for how QI should handle internal and external communications. Include in the report an analysis of the implications for staff, investors and the board if QI is sold to Lavender House.

**This should be written in the style of a report and include the following sections: Title Page, Contents, Introduction, Executive Summary, Main body of the report and Appendices.**

**Title Page:** Implications for QI of the Blackstuff Situation and Appraisal of Options for the Sale of QI

### Contents:



### Executive Summary:

- QI has been overexposed to the oil industry in West Africa and the recent investment in Blackstuff has precipitated a crisis in the Energy Fund.
- The Energy Fund is unviable in its current form. We should disinvest in Blackstuff as soon as possible and dissolve the fund.
- The possibility of legal redress against Blackstuff's auditors will be explored.
- An independent review of investment criteria and processes will be carried out to learn lessons from this situation.
- Additional helpful information should be available in integrated reports to support future investment decisions.
- QI's incident management team is taking effective action to manage the situation and is developing a communications strategy to restore investor confidence through promoting positive messages around QI's consistently strong fund performance against other funds, attractive ethical basis for investing, and strong management team.
- Selling QI to Lavender House would protect the interests of investors and staff, however further work needs to be done on the valuation and other issues related to the potential sale.

## 3.1 SECTION 1: Introduction and background

## Introduction

In early Yr21, QI invested in Blackstuff plc, an oil company operating in West Africa. Last night, news broke that there had been a major oil spillage in one of Blackstuff's oil rigs. This morning the company disclosed material errors in their reported oil reserves going back five years. Consequently, trading has been halted in Blackstuff's shares and we have suspended trading in QI Energy. All Commodities Fund is at risk if falling investor confidence spills over into our larger fund and effective action must be taken quickly.

QI was founded with the aim of promoting sustainable investment and sustainable practices among the companies that we invest in. It is clearly a blow that one of our significant investments has created an environmental disaster. We must move swiftly to exit from this investment, and we must move swiftly to manage our relationship with current investors as well as secure the confidence of existing and future investors.

This report gives the board key information about the Blackstuff situation and discusses the implications for QI. The report describes how we are handling the current crisis and sets out specific messages that will be included in internal and external communications.

## Background

Blackstuff is a relatively new investment for QI and features in our Energy and All Commodities Fund funds. All of QI's funds were valued at £285m at the end of Yr21. The largest fund is All Commodities Fund, which was valued at £195m at the same date. 25% of All Commodities Fund is invested in energy in the same proportions as in the Energy Fund (see Table 1).

Blackstuff comprises 25% of the Energy Fund (valued at £35m at the end of Yr21) and so it comprises 6.25% of All Commodities Fund. Using the Year 21 figures, QI had invested just under £21m in Blackstuff or 7.4% of total holdings (All Commodities Fund £195m x25% Energy Fund x25% Blackstuff = £12.19m) plus (Energy Fund £35m x25% = £8.75m).

**Table 1: Current composition of Energy Fund**

| Company | Type | Operational Area | % of fund |
|---|---|---|---|
| Blackstuff | Oil | West Africa | 25 |
| Guinea Group (Oil) | Oil | West Africa | 25 |
| Hydro Sun | Renewables | China | 10 |
| Nigeria Premium plc | Oil | West Africa | 20 |
| Turbo Turbine plc | Renewables | Europe | 10 |
| Western States Group (Oil) | Oil | North America | 10 |
| **Totals** | | | 100 |

It is clear that our exposure to geographic and sector risk has been too great: oil in West Africa comprises the largest component of the Energy Fund (70%) and a significant proportion of All Commodities Fund (17.5%). This suggests that we need to review our investment criteria and processes to ensure that they are fit for purpose. I intend to instruct an urgent independent review into the criteria we use and how decisions are made.

This review will include an investigation into the selection process for adding Blackstuff into the Energy Fund. At this stage, I am aware of nothing to suggest that any regulatory agencies need to be involved.

## 3.2 SECTION 2: Implications for QI- oil leak

A serious oil leak from one of Blackstuff's oil rigs in the Gulf of Guinea is causing environmental damage. This appears to have been caused by the lack of proper maintenance of the rig. The costs of addressing the leak will be substantial and there will also be reputational damage to Blackstuff. Loss of reputation might result in the company losing its licences to operate.

Blackstuff's major investor, Safecash, has expressed support for the company, however, this might be their way of trying to stop a further slide in the value of Blackstuff's shares until they can dispose of them. They also commented before further information emerged about the over-valuation of Blackstuff's oil reserves.

Other oil companies drilling in the Gulf of Guinea are affected and so it is likely that our other two oil companies could have been forced to stop drilling there. Their market value has already fallen by 50%. A loss of 50% equates to £7.9m (Energy Fund £35m x45%). Before trading in Blackstuff was suspended, the share price had dropped by 40% but it would be prudent to assume nil value now. Assuming a nil value for Blackstuff's shares, the Energy Fund is looking at a reduction in value of nearly 50% (Blackstuff £8.75m+Other oil companies £7.9m), calling its viability into question. The potential serious reputational impact on QI demands that the Energy Fund is closed and decisive action is taken to restore investor confidence.

## 3.3 Implications for QI - oil reserves

Blackstuff's oil reserves have been materially overstated for at least the past five years and their external auditors have resigned. In the latest audited statements, probable reserves should have been reported as 5m barrels (incorrect figure reported was 21m) and exploration reserves should have been 21m barrels instead of 5m, reducing the value of reserves in total from £159m to £79m (2m x £14, 5m x £6, 21m x £1).

The effect on the balance sheet and share price is significant. If the company's market value was £31.5m when the shares were suspended (at 45p per share) and the value of reserves has fallen by £80m, the company is now in a net debt situation and unlikely to survive.

It is probable that Blackstuff plc will not survive, unless shareholders invest significant finance into the business. Although their major investor, Safecash stated that they would support the company, they made this statement before the overvaluation of reserves was known.

It may be possible to recover damages from the external auditors and I propose to take legal advice on this.

## 3.4 Impact on the Energy and All Commodities Fund funds

The knock-on effect of Blackstuff going out of business is a reduction in the value of QI Energy by 48% (£17m); [(25% of QI Energy is £8.75m by value) along with the write down in value of our other West African oil investments (50% of £15.75m of the QI Energy Fund)].

Investor confidence is likely to be severely shaken and before trading in the Energy Fund was suspended, investors were starting to sell shares in the Energy and All Commodities Fund funds. Given the size of the reduction in value of the Energy Fund, it is unlikely to be able to continue in its present form as investor confidence is unlikely to recover and the Energy Fund will likely have to be closed.

For QI Energy, options exist to either i) sell the fund assets, return funds to shareholders and close the fund, or ii) sell the West African oil equities and merge the remaining assets into another fund. Both options would require Energy Fund investors' support.

For All Commodities Fund, a drop of 6.25% (£12.2m) in the value of the fund due to Blackstuff and 5.62% (£10.96m) due to the write-down of our West African investments means the fund has fallen in value from £195m to £171.8m (11.88%).

On All Commodities Fund, we need to act quickly to restore investor confidence. There is less likelihood of investor support collapsing given positive past performance of the fund.

However, it is likely that we will lose investors due to the drop in value and we need to build confidence in the fund and QI as a matter of urgency.

Closure of the Energy Fund and a reduction in value of All Commodities Fund would decrease the value to total funds under management to around £227 million. This is just above the value of funds under management in 2017 and whilst profits would be likely to fall to less than the 2017 level due to fixed costs, QI should still remain in a profitable position.

If profits reduced proportionally to fund size, around £4.5m profits would result (£5.7m x £227m/£285m).

**Table 2: Selected financial information (no technical marks)**

| | Yr17 | Yr18 | Yr19 | Yr20 | Yr21 |
|---|---|---|---|---|---|
| Total funds under management (£m) | 185 | 210 | 225 | 255 | 285 |
| Income from fees (£m) | 8.0 | 9.4 | 10.7 | 12.8 | 17.3 |
| Fund management & IT costs (£m) | (2.2) | (2.6) | (2.8) | (3.4) | (3.8) |
| Total expenses (excluding IT/fund management costs) (£m) | (4.6) | (4.9) | (5.2) | (6.4) | (7.8) |
| Operating profit (£m) | 1.2 | 1.9 | 2.7 | 3.0 | 5.7 |
| Profit as a % of funds | 0.6 | 0.9 | 1.2 | 1.2 | 2.0 |
| Income as % of funds | 4.3 | 4.5 | 4.8 | 5.0 | 6.1 |
| Fund management & IT as % of funds | 1.2 | 1.2 | 1.2 | 1.3 | 1.3 |
| Total expenses at % of funds | 2.5 | 2.3 | 2.3 | 2.5 | 2.7 |

## 3.5 SECTION 3: Possible additional benefits of using integrated reports to aid investment decisions

**[This section tests the students' awareness of integrated reporting and their ability to apply that knowledge and understanding to the Blackstuff scenario. The points included here are illustrative and students may make other relevant points worthy of credit eg. discussing the capitals in greater depth.]**

The extracts from the annual report may not present a full picture of Blackstuff. Recent developments in financial reporting have led to a future orientation for reports and a strong focus on governance and risk. This is useful information for investors, particularly socially responsible investors. It is possible, therefore, that the full annual report contains more useful information about Blackstuff's approach to social and environmental issues.

Some companies have adopted integrated reporting which means that they will report on the resources (capitals) used by the company to create value over time. Of particular interest to QI, is the information that may be disclosed about natural capital. The integrated report should disclose how the company uses environmental resources to achieve its objectives.

Similarly, disclosure about human capital should provide information about the company supports and develops its staff, including health and safety issues.

For oil companies such as Blackstuff, integrated reports would tend to include information about the company's approach to minimising environmental damage and environmental stewardship; supporting the local communities in which they operate through skills development and opportunities to be part of the supply chain; creating a diverse and well-trained workforce; fair pay policies; health and safety training and policies.

Although there is an internationally recognised integrated reporting framework, it is not mandatory, and it is principles based. Because there are no mandatory performance indicators or reporting requirements, comparisons between companies can be difficult.

For companies that comply with the Companies Act 2006 and are required to produce a strategic report, there is also a stronger focus on governance and risk as well as information about corporate social responsibility (CSR) in the form of economic, environmental and social impact. Some organisations, particularly energy companies, go beyond the statutory requirements and produce a separate CSR report each year.

Although CSR disclosures can be extensive, the challenge for users of this information is that there are no mandatory reporting standards and the reports are not subject to the same rigorous scrutiny standards as the audit of financial statements.

For the CSR information in the annual report, the auditor is required to read it and comment if the information is inconsistent with the auditor's knowledge of the organisation, gained through the audit of the financial statements. This is a low level of assurance and results in what is sometimes referred to as 'greenwashing' whereby companies discuss CSR in a way that presents them in the best possible light.

Some companies that produce separate CSR reports have them audited. But again, the assurance that is offered is not as high as that offered by the external auditor of financial accounts.

### 3.6 SECTION 4: Communication Strategy

As previously mentioned, QI's reputation could be damaged by the Blackstuff situation and possibly by some of our other West African energy investments. The importance of reputation and its impact on market sentiment and investor behaviour should not be underestimated. Therefore, how we handle the current situation and communicate our future strategy is crucial to the continued success of QI. Our incident management team has been invoked and will be meeting daily during the crisis.

In terms of the current situation, there are three stakeholder groups we need to focus on:

- our current investors who will be worried that their investments are at risk and who may seek to withdraw their funds but are unable to do this;
- future investors who will be concerned that QI will not be able to achieve sufficient returns and/or deliver on its commitment to invest only in companies with a strong commitment to sustainability;
- staff who will be concerned that their future employment may be at risk and who may be concerned that QI invested in a company which did not share its values (Blackstuff). The staff responsible for managing the Energy Fund will be particularly concerned.

The communications team have been very busy this morning. We have acted swiftly to inform current investors. A statement has been placed on our website to inform investors that trading in the Energy Fund has been suspended due to circumstances outwith our control but that All Commodities Fund is open for business as usual. We have said that the website will be updated when more information is available.

Staff have been briefed on the situation so that they are able to give consistent and correct information to investors on the phone.

Significant individual investors have also been informed of the situation and we have sought to assure them that we are working hard to resolve the situation for them.

QI has built a strong brand identity of investing in commodity companies which have a proven commitment to sustainability. We will issue a statement to the market later today that will seek to reinforce that message. The message will primarily be directed at current and potential investors. The board is asked to approve the following points which will be included in the message:

- QI was founded on the basis that investors could make a positive difference to the world by using their money to promote sustainable practices
- We only invest in companies which have made a strong commitment to sustainability
- We deeply regret the environmental damage caused by one of the oil companies we invest in, although this is something that was outwith our control
- We note the information released to the market this morning about the mis-statement of reserves in Blackstuff's audited accounts
- QI is led by a strong and effective management team and has a clear track record of success
- However, as an indication of how seriously we take our commitments, the senior leadership team will forego performance related bonuses this financial year
- Furthermore, the board is reviewing its investment strategy and we will be looking at ways of strengthening our measurement of sustainable investment.

It is likely that negative publicity about Blackstuff and QI will be picked up quickly via social media and will affect the value of QI. However, we have a strong reputation going back several years amongst investors and that may dampen the effect. We will need to actively monitor media sources to stay on top of relevant news and comments. The incident management team will receive daily updates.

Our communications team is developing a line to take for our website and social media feeds. This message will clearly state our commitment to sustainable businesses and reassure investors that QI is a safe place to invest, drawing on our extensive track record.

The communications team is also helping me to draft an all staff communication to help reassure staff that we are taking appropriate action and that their jobs are not at risk. Staff will be kept updated regularly.

Additional support will be provided to the Energy Fund management team as we manage the wind up of the fund and the redeployment of staff. There is no proposal to make staff redundant at this stage.

The situation with Blackstuff is serious – for the people and ecosystem directly affected by the oil spillage and for QI. However, we must not lose sight of the bigger picture. There is evidence to suggest that younger investors are making investment decisions based on factors other than risk and reward. In a recent report, it was noted that 77% of Millenial investors are influenced by environmental, social and governance factors when they consider investments. This means that we continue to operate in a market that is experiencing an increase in demand and our external communications will reinforce the message that QI is the place to 'Invest to build a better world.'

## 3.7 SECTION 5: Potential sale of QI – ACD

This section discusses the implications for stakeholders of the potential sale of QI to one of its competitors, Lavender House. The following issues are considered: price; cultural fit; implications for staff; governance; implications for investors. Appendix A sets out some key information about Lavender House.

As the authorised corporate director (ACD) of an OEIC, there is a legal process to be followed for QI to step down from the role and for another ACD to be appointed by the depositary. **Note: candidates who are not familiar with the legal structure should still be able to comment on the need for a legal/regulatory process to be followed.**

## 3.8 Price

QI is a successful and profitable business with a clear track record in a specialist area. This should make QI attractive to potential purchasers who already operate within the sustainable commodities sector, or who wish to move into that area. If the board decides to proceed with a sale, then a specialist valuer should be appointed to represent QI.

Similar asset management companies would be valued in the market at around 15 times the most recent annual profit figure. Based on the Yr21 profits, that would suggest a value of £85.5 million. However, profits are likely to be depressed in Yr21 due to the Blackstuff crisis. If profits reduce in proportion to the reduction in fund size caused by closure of the Energy Fund and reduced valuation of All Commodities Fund, a profit of around £4.5m would result, leading to a valuation of c£67.5m based on a multiplier of 15x. Given the unknown reputational impact on QI of the current crisis, realising any sum around £67.5m could be seen as a good outcome. **Note to markers: a different valuation amount based on a different adjusted profit is allowable.**

However, selling a company involves negotiation and although QI is only approaching one competitor, there may be scope to negotiate an increased selling price. This is also where a specialist valuer could be beneficial. The value of funds under management will influence the price as will QI's profitability. Other factors that will affect the price a purchaser is willing to pay includes: any contingent assets or liabilities; the calibre of QI's staff; the growth potential of the funds.

Based on what we know, Lavender does have sufficient cash resources to acquire QI and so could potentially be the purchaser.

Lavender has a relatively low level of gearing (22%). This suggests that they have scope to raise funds through borrowing if they needed to for future development or expansion. QI also has a low level of gearing and may be attractive to Lavender for that reason too since they would not be acquiring significant debt to service and would have assets to support potential future borrowing if desired.

## 3.9 Cultural fit

QI is a small organisation with stable leadership, a clear vision and engaged staff.

Although Lavender is larger than QI, it looks like a good cultural fit. Employee turnover and absence is low although pay is less than the sector average. This is similar to QI.

Lavender also has stable leadership and only acquires companies that are a good cultural fit. This suggests that if they are interested in QI, it is because they believe that the two organisations could merge effectively, and they are interested in more than just the added business that QI would bring.

Lavender has flexible and home working policies and reasonable working space standards for staff. Their management costs are similar to those of QI. This suggests that the working conditions partially compensate for the lower salaries. And that the QI staff should find that they would not lose their current working conditions.

QI has a clear vision and focus on sustainable investment in commodities. Lavender has broader strategies and so this could have implications for the motivation of staff who may be particularly attached to the current vision. However, the broader strategy might be attractive to staff who would like to diversify. QI does not have a clear strategic plan and so it might be relatively easy to align the QI business with Lavender's clear strategy.

Investors recognise QI's strong commitment to sustainable investment. Lavender does not have the same brand identity. This could be a selling point because it would help them acquire credentials in the growing area of sustainable investment.

## 3.10 Implications for staff – TUPE

The Transfer of Undertakings (Protection of Employment) Regulations (TUPE) would apply to the transfer of staff from QI to the new company. This means that all staff would be entitled to transfer to the new company on the same terms and conditions that they currently enjoy (except for pensions). Although this is an important safeguard, staff are not guaranteed to have the same job as before. Staff might find themselves in roles that they do not enjoy as much as their current roles, even if only for a transitional period.

This is particularly true of senior staff who may find themselves in roles where they have less authority or status than before.

However, TUPE is not a protection against future loss of employment. The new company would still be able to cut staffing for technical or economic reasons but if QI staff were made redundant (in the new company) their accumulated past employment would be relevant for any employment related severance payments.

### 3.11 Implications for staff – Other

Lavender is larger than QI and so there should be more promotion and personal development opportunities available to staff. 60%% of Lavender's senior managers are internal promotions. This suggests that Lavender pays attention to talent development. QI does not currently have a succession plan and so staff should welcome the approach taken by Lavender.

The transfer to a new organisation will be complex and time-consuming. Staff morale and welfare will need special attention. Although there are many positives associated with the sale of QI in the long term, the short-term disruption and the impact of change will be stressful for some staff. Staff may feel a sense of loss for their current jobs and for QI. Good communication and leadership will be essential to make the transfer as smooth as possible for staff and for business activities.

Transferring to a new organisation will disrupt 'business as usual' and special project arrangements will need to be put in place to deal with the transfer of staff, data and systems.

There will need to be an induction programme to introduce the QI staff to the new organisation and to help integrate staff from QI into Lavender. Staff in Lavender will also need to be supported through this process.

The transfer will add to the workload and pressures on staff as they learn new systems and become accustomed to working in the new organisation. Additional HR/OD support will be required during this period and some staff might choose to leave the organisation.

The new company might want to offer incentives to some key people in QI to encourage them to stay.

Lavender is based in Glasgow and so the disruption to travel for staff should be minimised. It is possible that QI's current offices could be retained, and this could be subject to negotiation.

The average growth of QI's profits was 7.5% over the period Yr16 to Yr21. This is less than that of Lavender (9.5%). This suggests that Lavender is a viable business and offers job security to staff.

### 3.12 Governance

TUPE does not apply to non-executive board members and so it is likely that non-executive board members will not be offered a board position in the new company.

Lavender has an employee director on the board to represent employees' interests and the pay ratio of the Chief Executive Officer to the lowest paid employee is a modest 10:1. Combined with the fact that the board includes three of the original founding family members, this suggests that the company is focussed on wealth creation rather than short-term gain. QI does not have an employee director and so this is an improvement.

Lavender has modern and up to date IT systems suggesting that they have a sound approach to data governance. This means that QI would not have to replace its current outdated systems and could adopt those used by Lavender.

## 3.13 Implications for investors

For current investors in the funds, their main concern will be around fund performance. Lavender already has Commodities Funds. Compared to QI's Yr21 position, Lavender's funds are more than three times greater. Therefore, Lavender is experienced in managing Commodities Funds which should be reassuring to QI's investors.

Despite scale, in Yr21, Lavender's RoI on its Commodities Funds was 12%. This compares favourably with the 12% benchmark but is less than QI's RoI of 20% for All Commodities Fund. This is an important selling point for QI but may be of concern for shareholders.

However, if the funds are still managed by the former QI staff using similar policies, current shareholders should be no worse off.

QI's investment policies are different to those of Lavender. Lavender has a limit of 20% invested in any one country or company. If the existing QI funds are reconfigured to comply with either of these policies, performance could go down.

QI is associated with a strong commitment to sustainable investment. Lavender does not have the same brand identity. This could discourage future investors from investing in the funds. But brand identity could be one of the reasons why Lavender might buy QI.

Lavender has modern trading platforms and apps. This should benefit shareholders.

Lavender has other funds and existing shareholders will have easy access to them.

## 3.14 Recommendations

Based on the previous appraisal, Lavender House looks like a good prospect for QI.

If the board decides to investigate the sale of QI further then it would be worth taking professional advice on valuation issues, regulatory issues relating to the OEIC, legal issues relating to staff consultation and HR matters.

Timing is important too. The Blackstuff issue will have at least a short-term impact on QI's profits. And since profit is a key driver of the valuation, the board might wish to investigate the sale further but refrain from making an approach to Lavender House until QI's profits recover lost ground.

## 4. ETHICS

**Personal notes to identify the ethical issues, possible actions and decisions.**
Consider: integrity, objectivity, professional competence and due care, confidentiality, professional behaviour

- I am in a difficult situation. My boss is encouraging me to behave in a way that would compromise my **professional behaviour** and **integrity**. She tried to steer me to give a positive recommendation about Blackstuff and now she is trying to persuade me to keep quiet about problems Blackstuff are having so that she and I can receive performance bonuses. If I speak to her boss, the Chief Executive Officer, this is likely to have an impact on my working relationship with my boss and possibly on her employment status. If I say nothing then I would gain financially but would have demonstrated to my boss that I can be persuaded to behave unethically. She may expect further unethical behaviour from me in future.
    - **Decision:** I did not compromise my professional behaviour and integrity when I appraised Blackstuff because I carried out an objective review and did not recommend investment. I will also disclose the problems faced by Blackstuff in the report to the board.
- It appears that my boss selectively used information and analyses that I prepared to persuade the board to make a poor decision (to invest in Blackstuff). This calls my **professional competence and due care** into question.
    - **Decision:** I will discuss this situation with the Chief Financial Officer.
- My boss is trying to pressurise me into keeping important information (the resignation of Blackstuff's auditors) quiet. This compromises my **integrity** and **professional behaviour**. If I tell anyone about this, I might not be believed.
    - **Decision:** I will disclose the problems faced by Blackstuff in the report to the board. I will also disclose the conversation with the Director of Investments to the Chief Financial Officer.
- I suspect my boss of accepting a bribe. I have no proof of this other than the knowledge that her brother is a senior employee in a company that QI has invested in despite my recommendation not to invest. She recently received an expensive gift from her brother and was on a skiing holiday organised by the company. This could be illegal therefore it would be a very serious accusation to make. However, to ignore these signs would compromise my **integrity**. There is also an impact on Emma's **professional behaviour** and potential compromise of her **objectivity**.
    - **Decision:** I need to find out about QI's whistleblowing policy and make use of this to report my concerns. Before I do this, I will contact ICAS to discuss my concerns on a confidential basis to make sure that I handle this properly.
- The Chief Executive Officer has disclosed that he prevented a serious loss of customer data from becoming known outwith the organisation. I infer from this that QI may be in breach of GDPR (DPA 2018). Data breaches of personal information must be reported to the Information Commissioner, normally within 72 hours, and the individuals affected must also be informed. QI could be at risk of a large fine and individual customers could be at risk of their data being misused.
    - **Decision:** In combination with all of the other issues that have arisen, I feel as if QI has an unsatisfactory ethical culture. I do not want to work in this kind of culture and I need to give serious consideration to whether I should leave or whether I should stay and try to change the culture. Given that the Chief Executive Officer is implicated, I am not sure whether other board members are aware of what happened and I shall use the Whistleblowing procedures to highlight the GDPR issue. I shall also phone ICAS to discuss what other courses of action may be available to me.