THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC5 - Corporate Strategy and Contemporary Issues

December 2017

(1) **Re assessment of Strategy, Decisions, Governance and Risk Management**

Strategy & Decisions

1. Offering discounts in partnership with credit card companies could be a good strategy to attract local travelers, but this is a promotional mechanism followed by almost all hotels and therefore lacks differentiation. The discounts do not appear to have been determined after an appropriate assessment of costs and with any targeted volume increase in mind, which could have resulted in further losses.

2. When promotions are targeted at local travelers one critical aspect is quality of food. The scaling down of buffet menu's to curtail costs could draw negative comments from the guests which could result in adverse opinions being made in the market place.

3. Reduction in staff could result in reduced level of service to the guest. This situation could further aggravate the drop in motivation of the employees due to suspension of rewards.

4. Curtailment of the maintenance budget could have an adverse impact on the ambience of the hotel resulting in negative remarks by the guests.

5. Athula Amarasuriya's vision to develop a chain of hotels was partly driven by the idea that the business connections of his wife and father in law would pay a role in creating the tourism market for the hotels. But he should have realized that connections in the semiconductor industry and pharmaceutical industry would make very little contribution in providing any tourism market.

6. Harsha Perera who was appointed as the Marketing Manager was inexperienced and it was his first employment. He does not have any experience in tourism marketing which requires specialized knowledge.

7. The contractors appointed to construct the hotels do not appear to have the competence and capability to undertake this type of work which resulted in considerable delays and losses to the company.

8. It appears that appropriate financial planning had not been done which failed to identify the working capital needs at the outset. If it was identified it should have been covered in the first share issue, as borrowings (even for working capital) may not be the right approach when the company does not generate any returns as interest cost would be a burden on the company.

9. Even after launch of the hotels, the marketing and promotional activities appear to be below the expected level. Business promotion expenses have been only in the range of LKR 10 – 13 million per annum during the last three years which would be grossly inadequate to promote two hotels for foreign tourists. Basic requirements such as being on Booking.com and TripAdvisor are not in place probably due to non-payment of subscription.

10. The funds have been utilized for activities not planned (investment in shares, Anuradhapura land, construction of Lagoon hotel, holiday bungalow in Kandy) which later resulted in not having sufficient funds to complete the construction of the two originally planned hotels. This resulted in delays and losses which had a serious adverse impact on the entire company.

Governance

1. The transfer of own land by the promoters to the company does not appear to have been done transparently where the value of LKR 1.4 billion looks arbitrary. The subsequent revaluation has been carried out by Mr. Boralugoda who may not have had the level of independence, being a long standing business partner of Gregory Wijesinghe. This view is substantiated by the subsequent impairment that was needed after the valuation carried out by the bank valuers.
2. Selection of contractors appears to have been done based on personal relationships of Athula and Gregory, rather than based on an objective evaluation of the capacity and proven capability of the contractors.
3. The funds raised from the share issue have been utilized to invest in shares, purchase of the property in Anuradhapura and to construct the hotel in Waikkal which were not in the initial plan communicated in the share issue document.
4. Lease of the holiday bungalow from Mihiri is a related party transaction and the investment has not been evaluated properly and the upfront payment of LKR 180 million was not in the original plan.
5. Independent non-executive directors are supposed to be those who are experts in relevant disciplines who could provide such expertise independently at the Board level. However the independent/non-executive directors appointed at the time of the planned IPO were not experts and are simply connected parties to the existing directors.
6. In spite of appointing a remuneration committee, all recruitment and remuneration decisions have been made by Athula and Gregory who are not even members of the Remuneration Committee. None of remuneration committee members were involved in these decisions.
7. Basic internal controls appear to have been violated, possibly due to the non-availability of sufficient funds. The hotel staff appear to have started to make their own decisions which has resulted in a breakdown of the decision making hierarchy.
8. No attention has been paid to Board balance and the division of power and authority. Most critical decisions have been made by Athula and Gregory.

Risk Management

1. They have not visualized possible cost escalations and construction delays. The contracts awarded do not appear to be fixed price contracts in which case such events should have been expected.
2. When the lands were originally purchased an appropriate market survey had not been carried out as to whether those locations could attract tourists.
3. Gregory and Athula, the key people behind the project do not appear to have a thorough knowledge of hotels and tourism in spite of Athula having been the CEO of a small resort. Richard although a veteran in the industry does not appear to have a thorough knowledge of the industry in Sri Lanka. He was initially involved in the construction of the properties of which he had little knowledge.
4. Borrowings have been made as and when the company has faced funding shortages without an adequate evaluation of impact and risk.

(2) **Conflicts**

The Company does not appear to have a career path for the employees or a succession plan which has led to the present conflicts.

Functional conflict is sometimes good for performance.

Director resigned, replaced with a promotion to CFO after which the GM left.

Since Sudath has already resigned, the condition is not dysfunctional.

Therefore new recruitments may not be advisable considering the experience and loyalty of the Accountant and Marketing Manager.

It's a good opportunity for the company to show that there is a career path for good performers.

Either the Accountant or Marketing Manager may be promoted and have a mechanism to retain the other.

- Promote both as GM-Finance and GM-Operations
- Promote one as GM and give the other an enhancement in designation
- Promote one and give the other an attractive remuneration package

(3) **Accounting Treatment of Facility Restructuring**

LKAS 39 para 39-41 applies

"……… A substantial modification of the terms of an existing financial liability ……… shall be accounted for as an extinguishment of the original financial liability and recognition of a new financial liability".

IFRS 9 provides specific quantitative guidance as to what is "substantial".

Discounted PV of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10% different from the discounted PV of the remaining CF of the original financial liability (IFRS 9.B3.3.6)

The current outstanding balance according to bank records is LKR 2,250 million.

The modifications will result in the total liability reducing by LKR 250 million (160 + 40 + 50).

Modifications account for 250/2,250 = 11.1%. Consequently the modifications can be considered substantial being >10%.

Accordingly the present liability shall be derecognized, the new liability is recognized together with any gain or loss.

The existing liability would be derecognized and the new liability would be recognized at LKR 1 billion (after the settlement of LKR 1 billion) and a gain of LKR 250 million would be recognized on modification.

LKR 500 million out of LKR 1 billion which is within the overdraft facility would be classified as a current liability; LKR 100 million (Payable within the next 1 year) of the soft loan of LKR 500 million will also be classified as a current liability; The balance LKR 400 million will be classified as non-current liabilities.

(4) **Structuring methods and regulatory issues**

(a) **Option 1**

CIC can become a shareholder by acquiring a few shares in the market. Thereafter the company can make a rights issue at the price agreed with CIC with the undertaking that the present major shareholders (Athula and his allies) would not accept the rights. So that CIC would make an application for additional rights through which CIC could secure the majority number of shares post rights.

The regulatory provisions would be as follows:

- The existing shareholders will have to support a resolution in favour of the rights issue
- The SEC will request for an independent confirmation on the fairness of the rights issue price
- CIC may have to make a mandatory offer to the other shareholders under the TOM code
- Approval of lenders (Banks) may be necessary with regard to the covenants relating to change of controlling ownership

(b) **Option 2**

The company could make an application to the SEC for a special approval to issue shares to CIC.

The regulatory provisions would be as follows:

- The company will have to obtain approval from the SEC to issue shares to CIC
- The existing shareholders will have to support a resolution waiving off their pre-emption rights and issuing shares in favour of CIC
- The SEC will request for an independent confirmation on the restructuring plan and on fairness of the share issue price
- CIC may have to make a mandatory offer to the other shareholders under the TOM code
- Approval of lenders (Banks) may be necessary with regard to the covenants relating to change of controlling ownership

(5) **Offer Price**

Refer **Working 01** for the related calculation of FCF based value which indicates a value of LKR 4.40 per share.

Therefore the offer price of LKR 4.50 per share is not far from this calculation.

Considering the following risks associated with some of the estimates that have gone in to the computation the price may even be at a premium:

- The accuracy of the relationships derived based on market research;
- The moderate COE 18% in Sri Lankan context used in the computation;
- Maintaining a revenue growth of 10% largely on the pricing;
- Maintaining a GP margin of 60%;

Therefore in spite of not having an explicit control premium, the offer price may include a reasonable premium. The PV of FCF to an extent also includes the intangible component of assets which is paid for partially contributing to the premium.

The implicit PBV based on ANAV is 0.69 whereas the sector PBV is around 1.8 times. PBV reflects the quality of assets and their capability of generating returns higher than normal. As it stands now the company has no such potential due to its inefficiencies. Based on the sector PBV the share may have the potential to increase its value subject to its ability to sort out the current issues by attracting new investment.

The forward PE (2020/21) will be 4-5 times compared to the present sector PE which is in the range of 50 times. Though the present sector PE is distorted by outliers, even the adjusted PE would be significantly above 5 times. Therefore based on forecast earnings the share has the potential to reach higher price levels. However the company needs fresh investments to attain the forecasted earnings.

Based on the aforesaid the PBV and PE methods at this stage are inappropriate to be considered as they are subject to injection of new funds. Consequently the opportunity needs to be evaluated based on the FCF based valuation. Therefore considering the current status of the company, there will be further deterioration if no investment comes in, the offer of LKR 4.50 per share can be justified.

Working 01

Current stated capital (million)

	No. of shares	Equity
First share issue Dec 2010	140	1,400
3Q 2011	100	1,200
1Q 2014	50	600
1Q 2015	100	700
	390	3,900

			Cash flow
BV of Equity 31st March 2018		3,180	
Loss on sale of idle land	550		400
Impairment of Properties	150		
Loss on transfer of lease property	31		100
W/off RP/CA/AFS	169		
W/b of restructure liability	-250		
Adjustments to Equity		650	
Adjusted NAV		2,530	500
Capital infusion		1,845	1,845
Total Equity		4,375	2,345

Promotion cost and Occupancy

$Y = -x^2 / 200 + 0.4x - 7.2$
$dY/dx \quad = \quad -x/100 + 0.4 = 0$ when Y is maximum
$x = \quad 40$ when Y is maximum

$Y(x = 40) \quad = -40^2/200 + 0.4 \times 40 - 7.2$
0.8

Promotion cost to be LKR 40 million to achieve maximum occupancy of 80%.

Free Cash Flow Valuation

		-1	0	1	2	3	4	5	
		2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	
	(LKR million)								
Revenue				2,400	2,640	2,904	3,194	3,514	
Contribution	60%			1,440	1,584	1,742	1,917	2,108	
Fixed cost	5%			400	420	441	463	486	
Promotion cost				40	40	40	40	40	
				440	460	481	503	526	
Profit = FCF		-	-	1,000	1,124	1,261	1,414	1,582	
TV of FCF								9,120	
DF **(Working 02)**	17.35%	0.85	0.73	0.62	0.53	0.45	0.38	0.33	
PV		-	-	619	593	567	541	3,493	5,812

Assumptions

1. Depreciation = Capital investment
2. Working capital infusion not necessary
3. LKR 1.3 billion would be sufficient to construct the two hotels
4. Any shortfall can be temporarily funded and settled with Y3 cash flow

PV of FCF	5,812
Incremental investment	(1,300)
EV Post Money	4,512
External liabilities	(1,000)
Equity value post money	3,512

No. of shares	800
Value per share post money	4.39

Working 02

Weighted Average Cost of Capital

MV of Equity	3,600

Computation of WACC

Equity (Adjusted)	3,600	18%	648.00
Soft Loan	500	14%	70.00
POD	500	16%	80.00
	4,600	17.35%	798.00

Earnings per share 2020/21

Profit before interest in 2021	1,000	
Interest	150	
Net Profit	850	
EPS (LKR)		1.06
Foreword PE 20/21 (No. of times)		4.24

Adjusted Net Asset Value

Adjusted NA Value (LKR million)	2,530	
No. of shares (million)	390	
ANAV per share		6.49
Implicit PBV		0.69

(6) **Tax implications**

The present tax loss may give rise to a deferred tax asset but may not have been recognized in the financial statements due to uncertainty prevailing over its realization.

With two new hotels that would be added there would be a considerable amount of capital allowances which could bring the taxable profits below the accounting profits. With the utilization of b/f tax losses the company's cash tax payments could be low during the initial years.

The valuation calculations have ignored the tax implication completely and therefore, if at all, there could be incremental tax payments which will decrease the share value. Considering these implications the offer is further justified as it is assumed that there would not be any tax payments.

Any penalties, surcharges have not been accounted.

Company may apply for BOI or QP relief

(7) **Sustainability practices and reporting**

Environment sustainability practices should be encouraged. The processes at hotels should be monitored, perhaps consideration of waste management, green promotions, sustainable energy sources etc. and reporting on it with reference to GRI guidelines or other similar frameworks.

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