

Corporate Strategy and Contemporary Issues

Instructions to candidates

- (1) Time allowed: Reading and planning – 20 minutes
Writing – 3 hours
- (2) Total: 80 marks
- (3) The examination will be conducted as an open book examination.
- (4) This question paper should be answered entirely in the **ENGLISH** language.
- (5) Your answer must be submitted in the answer booklets provided at the Examination Hall.
- (6) Any pre-prepared papers included in your answer WILL NOT be marked.
- (7) After the instruction to stop writing at the end of the paper, you will be given five minutes to assemble your answer booklet/s.

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**DECEMBER
2017**

Sun Asia Leisure PLC

You are an assistant manager of Marvelous and Genius Consulting Group (MGC) and have been working for the last two years. Sun Asia Leisure (SAL) has retained MGC to advise them on the potential strategic investment by Chelsey Investment Corporation (CIC).

You have been assigned by your director as the lead consultant to this assignment and have received the following email from him.

Dear Lead Consultant, SAL Project

This email refers to the discussions we have been having with regard to the advisory consulting assignment of SAL. SAL has now formally appointed us as its advisor to the proposed strategic investment transaction.

*I trust you have read the background information contained in the pre-seen which was available a month ago, and obtained a sound understanding of the contents therein. That document also included the summarised financial statements of SAL in **Annexures 1 and 2**.*

*SAL has sent further information which I have attached as **Annexure 3**. In addition, you will find a letter (**Annexure 4**) sent by the managing director of SAL requesting us to advise on **seven** matters. I would like you to peruse all this information together with the letter in **Annexure 4** and prepare a draft report addressing the matters raised in the said letter.*

Once the draft report is ready we will review it. Please have all the workings ready as they would be helpful in reviewing and understanding the draft report.

*Regards,
Director*

Required:

Prepare a draft report responding to the matters raised in the letter sent by the managing director of SAL to the director of MGC.

Mark allocation	Marks
1. Corporate management	22
2. Conflicts	6
3. Restructuring proposal offered by the bank	6
4. Structuring methods and regulatory issues	10
5. Offer made by the investor	24
6. Tax implications	6
7. Sustainability practices and reporting	6
Total	80

Annexure 3: Additional information Sun Asia Leisure PLC (SAL)

Chelsey Investment Corporation (CIC), having performed the preliminary analysis of the financials of SAL and also having studied the market research report, appointed Blue Green & Company (BGC), an investment advisory firm, to conduct a due diligence exercise and valuation of SAL. BGC was also requested to negotiate with the banks to restructure the borrowings.

The report of BGC was received by CIC in mid-December 2017 and certain extracts of this report are given in **Annexure 3A**.

Having considered all the information available, CIC has offered to invest in 410 million new shares of SAL at a price of LKR 4.50 per share. CIC has indicated that it has used 18% as the cost of equity in arriving at this offer.

CIC has briefly indicated its restructuring proposals for the company as follows:

1. The investment would be made on 1 April 2018 by infusing the entire amount of the investment into the company in cash.
2. Immediately after the investment is made, construction of the Anuradhapura and Waikkal hotels will recommence. The construction would be expected to be completed in two years (i.e. by 31 March 2020) at an incremental cost of LKR 1.3 billion.
3. Other idling land would be immediately sold for cash. The leasehold property (bungalow in Kandy) and the AFS financial assets would be transferred back to Athula and Mihiri for LKR 100 million in cash.
4. The concessionary package negotiated with the banks as given in the due diligence report would be accepted.
5. The annual promotion and communication expenditure budget would be set at the optimal level from 1 April 2020 so that occupancy would be maximised according to the model developed consequent to the market research.
6. In 2018/19 and 2019/20 the two hotels (in Pasikuda and Unawatuna) would operate at the break-even level.
7. During the five years commencing from 2020/21, revenues are expected to be in line with the model developed consequent to the market research, and the four hotels as a whole are expected to generate a contribution of 60% on revenue. Fixed costs, excluding promotion and communication costs and interest cost, would be LKR 400 million in 2020/21 and will increase at 5% per annum for five years.
8. Foreign travel agents will pay booking fees 2-3 months in advance. Hence incremental working capital would not be required to operate the two new hotels. Routine capital expenditure will be managed with an amount equal to depreciation.

The offer price by CIC for the shares initially came as a shock to Athula and the other directors on the board as they expected a value in excess of LKR 8 per share based on the estimated forecast financials prepared by Herman Mendis. Therefore, the board of SAL decided to further negotiate the deal and appointed MGC to advise them.

Annexure 3A: SAL - Extracts of the due diligence report

1. Property

Based on a valuation carried out as at 30 November 2017 by Sugath Francis, an independent chartered valuer, the current values of the undeveloped and partly developed properties owned by SAL are as follows.

Property	Book value* (LKR million)	Fair value (LKR million)	Forced sale value (LKR million)
Anuradhapura	500	400	300
Waikkal	400	350	250
Tissa	300	250	150
H'tota	400	250	150
Weligama	250	200	100

* Book values are those stated in the forecast statement of financial position as at 31 March 2018, and are stated at cost/revaluation of land plus any developments.

The valuations as at 30 November 2017 are not expected to materially change during the next six months.

2. Borrowings from financial institutions

The total principal amount likely to be outstanding by 31 March 2018 (both current and non-current) includes an amount of LKR 250 million, which was created by converting overdue loan payments and interest. LKR 50 million of unaccounted interest is part of that amount.

During the negotiations with the banks the following were provisionally agreed.

- To write-off the LKR 160 million of overdue interest recapitalised on the aforementioned liability of LKR 250 million.
- To write-off the penal charges of LKR 40 million.
- To reverse LKR 50 million of 'interest on interest' accumulated in relation to the bank overdraft.
- To settle immediately LKR 1 billion upon which the above concessions would be effected.
- To restructure LKR 500 million into a soft loan at an interest rate of 14% per annum on the reducing balance basis, where the capital would be repaid at LKR 100 million per annum commencing from the end of 2020/21.
- To grant an overdraft facility of LKR 700 million within which the balance amount of liability would be accommodated, and the average balance of the bank overdraft to be maintained at LKR 500 million. The interest rate would be 16% per annum.

3. Amount due from related parties

The amount due from related parties of LKR 100 million is unlikely to be recovered. The initial amount, which stood at LKR 300 million as at 31 March 2013, has been reduced to the present LKR 100 million by setting-off against various services claimed to have been provided by such parties.

4. Other current assets

54% of other current assets have aged more than one year and are unlikely to be recovered.

Annexure 4: Letter from the managing director of SAL to the director MGC

Director
Marvelous and Genius Consulting Group
Colombo

Dear Sir

Appointment as Advisors to the Board of Sun Asia Leisure PLC

We refer to the recent discussion we had with your firm on the above matter and are pleased to inform you that the board of Sun Asia Leisure PLC (SAL) has approved your firm's appointment subject to the signing of a non-disclosure agreement.

The board has deliberated the current status of the company and the offer made by a potential investor to invest in the company. The details were made aware to you at the discussion and we will provide you all the supporting information upon signing of the non-disclosure agreement.

The board consults you on the following.

1. Corporate management
We strongly believe that our strategies worked well in the past. However, we would like to have an independent re-assessment of our management strategy, decisions, governance and risk management practices. Please report on any significant findings thereon.
2. Conflicts
We are unhappy that Sudath Silva resigned and had to fill his position with Herman temporarily. I would like to advertise and recruit a person to fill this position to avoid internal conflicts. Evaluate how this would affect the performance of the company.
3. Restructuring proposal offered by the bank
CIC has asked us to apprise them, when the restructuring proposal of the bank is accepted, how it would be reflected in the financial statements as at 31 March 2018. Advise on the relevant provisions and impact on the financial statements based on applicable financial reporting standards.
4. Structuring methods and regulatory issues
Propose alternate methods in which the envisaged investment could be structured within the present regulatory framework. Please outline the regulatory matters that the company would need to pay attention to and be prepared for in each of the alternate methods.

5. Offer made by the investor

As you are aware, the investor has offered a price of LKR 4.50 per share to buy 410 million new shares of the company. This will give the investor a post-investment stake of a little more than 50% of the company. Based on the projected financials for 31 March 2018 the net asset value (NAV) per share of the company is in excess of LKR 8. The investor has indicated that its offer price is based on discounted cash flows (DCFs).

Please advise on the value proposed by the potential investor supported by your independent computation(s) together with any other matters that we should take into account when finalising the deal.

6. Tax implications

Presently we have a tax loss of nearly LKR 1.5 billion. Please advise on the implications of this tax loss and any other tax implications of the restructuring proposals and plans of the investor on the aforesaid valuation. (You are not required to recalculate the value or quantify the implications)

7. Sustainability practices and reporting

We acknowledge the responsibility for a sustainable environment. Please recommend how to ensure this and report on it thereon.

We would be pleased to receive a report addressing the aforesaid matters within a reasonable time frame.

Thank you.

Yours sincerely

Athula Amarasuriya
Managing Director
Sun Asia Leisure PLC