



THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

MULTIDISCIPLINARY CASE STUDY EXAMINATION

NOVEMBER 2009

Important - This question paper should be answered entirely in the **ENGLISH**
Language only.

**THE EXAMINATION QUESTION, INSTRUCTIONS AND
ADDITIONAL (IMPACT) INFORMATION**

Time allowed : 4 Hours

Marks : 100 marks

CASE STUDY REQUIREMENT

‘VC Colombo’ is the Sri Lankan centre of ‘Vision Capital’, a UK based corporate consulting group. Vision Capital UK is headed by a globally recognized author in strategic management. **You are Sandani Gamage, an executive working for Mr. Jon Lloyd - the UK representative and head of VC Colombo.**

Mr. David Brocksom, the Finance Director of Holmes Coal & Studland PLC (HCS), has sought VC Colombo's assistance in order for them to determine the feasibility of an investment in Domestic Energy (Private) Limited.

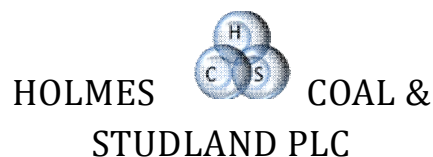
You are required to prepare :

- (i) An internal memo to Mr. Jon Lloyd, evaluating the Strengths, Weaknesses, Opportunities and Threats as applicable for Domestic Energy (Pvt) Limited, supporting him in providing consultancy services to HCS.
(10 marks)
- (ii) A report for Mr. David Brocksom, as required by his letter to Jon Lloyd (**Exhibit 7**) and further explained in the email from Jon Lloyd to you (**Exhibit 8**).
(90 marks)
(Total 100 marks)

State your assumptions (if any), separately as an annexure.

Exhibit 7

Blyth Road, Greenfield
DN12 9DB
www.holmescoal.com



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f: +44 (0)1302 752620
enquire@holmescoal.com

08th November 2009

Vision Capital Colombo
Jon Lloyd

Dear Jon,

Further to the discussions we had.

We have focused on developing new relationships with strategic partners; we believe that Sri Lanka offers immediate opportunities to develop power projects, in particular in the post war era. After a few successful discussions with Dr. Pitawala and the executives from Domestic Energy Limited (DEL) in Sri Lanka, we have signed a Letter of Intent which by itself shall not constitute or give rise to an obligation by Holmes Coal to make Equity or Debt Investment or otherwise provide any funding. The Letter of Intent shall not be binding on the parties thereto. The directors of Holmes Coal are ready for an investment in Sri Lanka. The investment options we considered are as follows.

Alternative 01:

Invest \$ 100 million in 11.5 million Unsubordinated Bonds of SLR 1,000/= each. The coupon would be 10% p.a. and bonds would mature on June 30, 2022. DEL needs to agree with one of the following options which would be exercisable at any time after June 1, 2019.

- Bonds may be converted into common stocks at \$ 0.33 per share; or,
- HCS may sell all the bonds back to DEL at par.

I look forward to have, your views in deciding the most suitable option in the context of the Sri Lankan capital market.

Alternative 02:

Invest \$ 100 million in Loan Stock, redeemable annually from 2013 through 2022 as suggested by DEL in their operating statement. **(Exhibit 5)**

The Holmes board of directors wishes to disburse money before the IPO as the project is to be started in 2010. However, other equity investors' funds should be realized beforehand and the auditors of DEL should certify to this effect. Personally, I do not think Holmes should buy common stocks of DEL in 2019. Could you recommend strongly on these alternatives and embedded options?.

a) Exclusive Coal Supplier

Agreement has been reached to supply total requirement of thermal coal to DEL continuously over 15 years operating period. The supply price is fixed at a discount of 10% of the average thermal coal price in the US and UK markets. Recently, we have sent our proposal to Lanka Coal Company (Private) Limited in response to their invitation in September 2009 to supply about 3 million metric tons of coal. We received a positive response and we are planning to send shipments.

b) Power generation in Sri Lanka

We are looking forward to having your views in understanding the future of the Sri Lankan power and energy industry and the power sector in the Colombo Stock Exchange. Holmes would be happy to take part in equity of DEL in case the company expands its business in to power transmission and distribution. Dr. Pitawala wants to establish a cleaner energy project, a wind farm in Sri Lanka in collaboration with our Harworth Estate wind farm portfolio. The suggested plant capacity is 30 MW and the investment would be about \$ 53 million. The presentation done by DEL for our board was attractive; however, they quoted a study done by National Renewable Energy Laboratory of the USA in 2003.

c) Reliability of Capital Market of Sri Lanka

DEL has suggested an IPO of 156 million (net issue to the public) equity shares priced at SLR 36, 38 and 40 in a book building process. However, it is our belief that the price is overstated. This offer for subscription would be about 50% of the entire issue (the balance goes to their holding company). We observed that a wholly Sri Lankan equity company, Hemas Power Limited, issued equity shares recently at a lower price. I remember what happened in the biggest IPO in the Indian market; the price of Reliance Power stock plummeted on the very first day of trading, taking the Bombay Stock Exchange's Sensex Index with it. However, DEL's Finance Director assured that the deal would be well received in the market. What is your opinion, does DEL have the earnings to justify the valuations? Could Sri Lankan market buy stories of non-existing businesses?

d) Investment appraisal

What is your independent assessment of this project's viability; would it be a sustainable strategy in Sri Lanka? Consider the following matters as applicable for Sri Lanka.

1. Are the cash flow estimations reliable?
 - a) Consider whether all the possible cash flows are taken into account and reflect the best estimates e.g. Prices in the global coal market?
 - b) Consumer tariff structure and marginal selling price per kWh
2. The operating cash flows submitted to us shows a negative NPV at 15%, DEL's Weighted Average Cost of Capital.

I'll keep you informed on any developments subsequently.

Your report would be tabled at the next Board Meeting.

Best rgds

David Brocksma

Exhibit 8

From: Jon Lloyd <jlloyd@vcnet.lk>
Date: 19. Nov. 2009
To: Sandani<sandanigam@vcnet.lk>
Subject: Holmes & DEL funding arrangements

Dear Sandani,

Even though the print media reported last week that Sri Lankan assets are going to be sold to England again, Holmes Coal is not interested in becoming a system operator Sri Lanka. Did you discuss with Handagoda about detailed financial analysis of the project? I have left some of the documents regarding Holmes Coal investment advisory on your desk; email from DEL (**Exhibit 9**), extracts from the prospectus of NAMAL Acuity Value Fund (**Exhibit 10**) and extracts from the report of National Renewable Energy Laboratory (NREL) of USA (**Exhibit 11**).

Ms. Handagoda at DEL said that they had meetings with provincial leaders, representatives from the Holmes Coal, CEB and Trinco City officials. After site visits and meetings a preliminary agreement has been signed with the CEB. The agreement promised DEL the exclusive right to develop the project. Holmes Coal, DEL and CEB are the parties to the agreement for 300 MW; 2-unit coal-fired power plant goes over twenty years from start of construction. It is a build-operate-transfer basis agreement expected to start operating by 2013. The power and energy ministry has issued an approval letter for the project. Subsequently, DEL has arranged for a site study to be performed by Reliance Power Limited, the giant Indian power producer.

IPO over priced?

Handagoda explained to me that they reached the IPO price based on a number of approaches including market and industry price earnings ratios, industry price to book value ratio, the return to Total Return Index of the Colombo Stock Exchange (which is a general stock market indicator). She further said that the overall project funding has been decided now with about 52 percent equity thereby leaving 48 percent for debt, a better condition than the industry except for Hemas Power Limited.

Non-financial measures

David wanted me to report on mitigatory measures of social impact of the power project, I inquired from Handagoda last week and she has already replied (**Exhibit 9**).

Financial appraisal

David said that it would be difficult to convince the board that investing in the project is indeed beneficial to the company. If so, the investment would not happen. He was uncertain that the cash flow projections had incorporated all the risks associated with the project. Handagoda has evaluated cash flows using conventional methods namely NPV and IRR. David wanted further analysis; sensitivities on key assumptions and application of beta to levered project. He questioned the sensitivity analyses that compounded an assumed inflation rate over the entire term of the debt and sought to determine the project's level of vulnerability to rising inflation.

David inquired on repatriation of profits too; please instruct on the legal implications including tax concerns.

Thanks

Jon Lloyd

PS. I don't have to remind you that the other members of the HCS board are not accountants.

Exhibit 9

From: Dinesha Handagoda <dinehanda@del.com>
Date: 15. Nov. 2009
To: Jon Lloyd <jllloyd@vcnet.lk>
Subject: Sampur coal project social impact assessment

Dear Mr. Jon Lloyd,

Board decision on Project Financing

We decided to have Rs. 11.5 billion debt in financing structure.

Option

In the event that HCS exercises the option DEL would obtain a listing in the debt market. Hence, HCS may participate in the market. Our Directors suggested creating reserves annually.

Eviction and Resettlement

As we have good experience at Norochcholai, Sampur was properly planned to minimize the social and environmental impact. I have noted below some of the key points.

- 60 Families would be evicted from their land. They are mostly illegal settlers (living in temporary huts)
- The relocation site has already been selected and the government has approved same (about 20 km from the site)
- Each family has been promised:
 - 12 perch block, 500 square feet house with 2 bed rooms, one living room, kitchen, toilet and drinking water well (Cost per Unit Rs 800,000).
 - 300 perch land for agriculture – farming families) (Fisherman will get fishing gear, bicycle etc)
- 60 housing units divided into 6 lots, each consisting of 10 housing units. Housing to be completed in 4 months time.
- Community hall.

Any possible community conflict would be resolved by the government. A police post would be set-up near the beach site of the coal plant. Possible concerns are sea erosion affecting the power plant and jetty, sulphur dioxide emissions which contribute to acid rain, discharge of warm water chasing away the marine life while harming the breeding too, fly ash, coal dust and noise. Our chairman is very particular about social responsibility. Therefore he would not leave any of these matters unresolved.

Rgds

D Handagoda

Exhibit 10

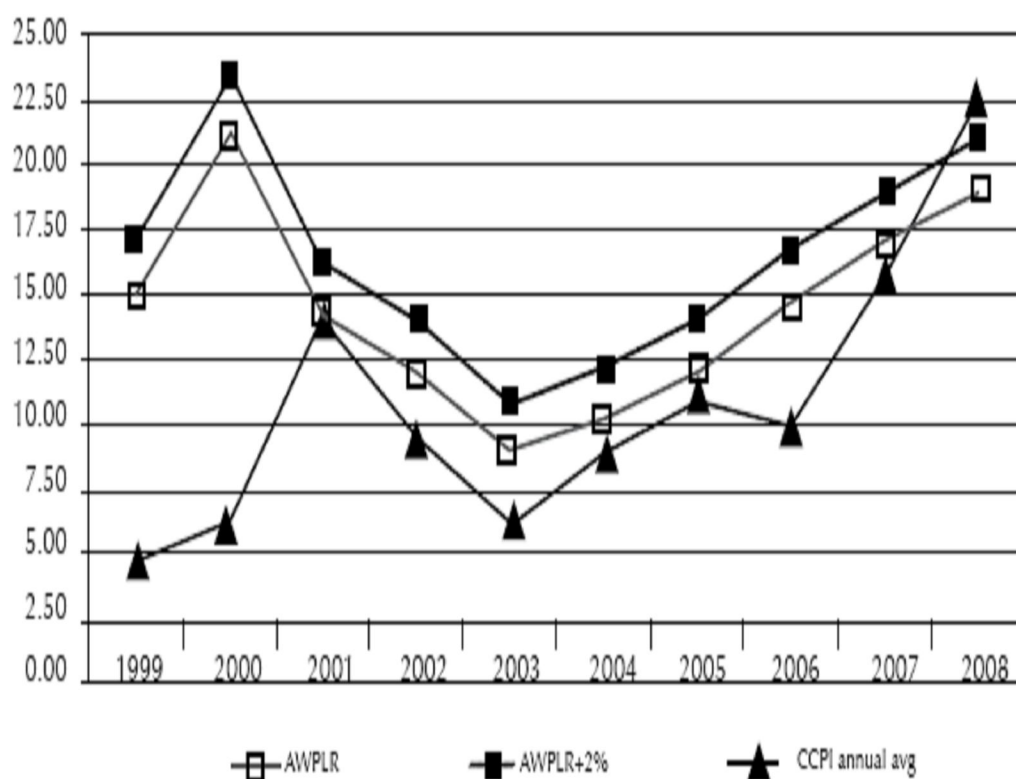
Extracts from the prospectus of Namal Acuity Value Fund

Fixed Income Markets 1999 to 2008

Nominal interest rates in Sri Lanka have generally closely followed headline inflation as measured by the Colombo Consumer Price Index (“CCPI”). Investments in corporate fixed income securities which are usually priced at a premium over the Average Weighted Prime Lending Rate (“AWPLR”) have traditionally yielded a positive real return, as depicted in the graph set out below, assuming an average premium of 2.00% p.a. over the AWPLR. However, investments in corporate fixed income securities carry an element of credit risk, although defaults among reputable and credit rated issuers in Sri Lanka have thus far been rare.

Exhibit 10 (A)

Corporate Debt Yields Vs Inflation Rates



Note : CCPI annual avg : 1999-2003 - base year 1952=100
2004-2008-base year 2002=100

Exhibit 10 (B)

Post IPO Annual Average Holding Period Return

Stock Code	Return % per annum
SLT	24.2
HHL	18.9
SIERA CABL	- 12.3
LIOC	- 13.3
DIALOG	- 17.2

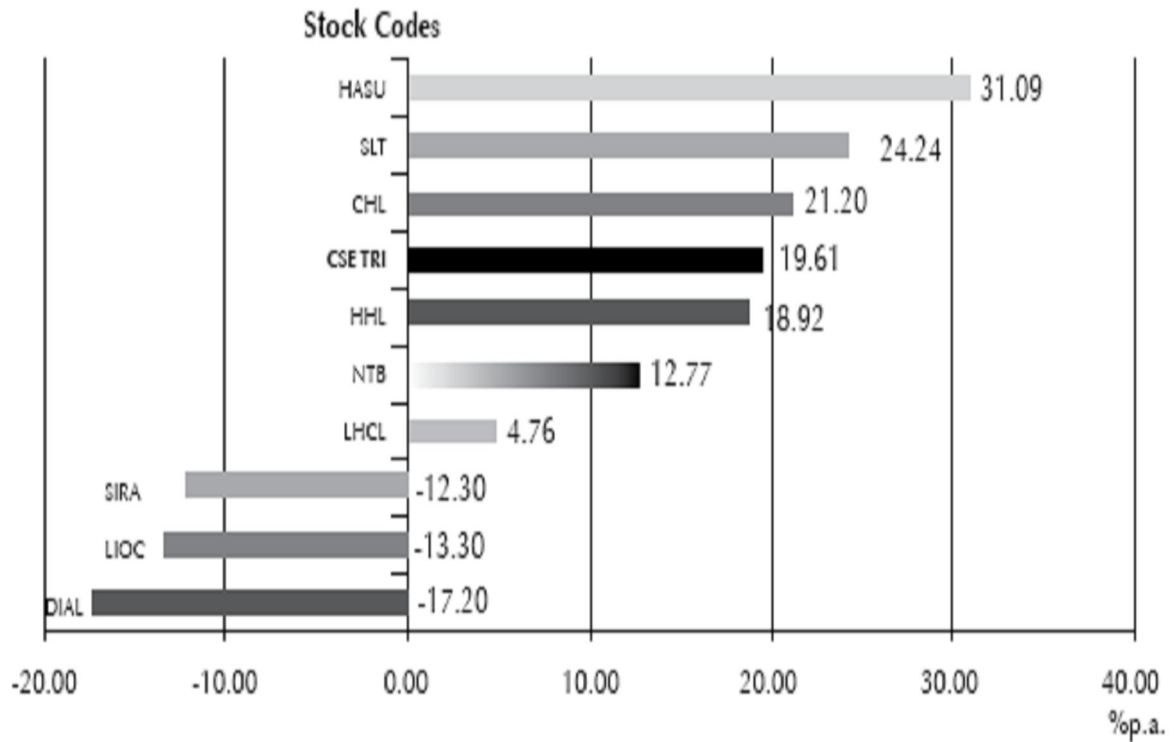
Exhibit 11

Extracts from the Report of NREL, USA

Table 6-1. Cumulative Site Evaluation Scores

Criteria	Southeast Coast	Kalpitiya Peninsula	Mannar Island	Jaffna	Ambewela Cattle Farm
Wind resource density based on NREL map	2	3	3	3	3
Weighted Score (multiplier = 5)	10	15	15	15	15
Proximity to transmission lines	4	4	1	1	4
Upgrades required to existing transmission lines or substations	3	1	1	1	5
Terrain	5	5	5	5	2
Accessibility	4	4	1	1	1
Terrain orientation to prevailing wind	3	4	5	5	3
Neighbor or community concerns	5	3	1	1	5
Land costs	5	5	5	5	5
Vegetation over 10 m	5	5	5	5	5
Soil conditions	5	5	5	5	4
Site environment issues (corrosion, humidity)	2	2	2	2	3
Cultural or environment concerns	3	5	5	5	5
Aviation and telecomm conflicts	5	5	5	5	5
Site Related Subtotal	49	48	41	41	47
TOTAL SCORE	59	63	56	56	62

Post IPO Annual Average Holding Period Return



AWPLR

AWPLR+2%

CCPI annual average

Note: CCPI annual average: 1999 - 2003 - base year 1952 = 100
2004 - 2008 - base year 2002 = 100