THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA



# SUGGESTED SOLUTIONS

## 27510 - TOP CA CASE STUDY EXAMINATION

December 2012

Given below is an answer script which is provided as an example of the sort of answer that candidates manage to achieve when sitting the TOP CA Examination.

Rather than showing an unrealistic "model" answer – written by the examiners themselves- which could not be achieved under normal exam conditions, this script is prepared based on both Examiner's model answer and answer scripts of clearly competent students. Objective of this answer is to show the sort of answer that is written by a successful exam candidate.

Please note that there is no pre-determined one answer which is considered to be the correct and model answer for a TOP CA Case Study Exam Paper. In any case study type paper, there is no correct or wrong answer but success depends on the extent of applying analytical techniques, demonstrating of technical knowledge and professional skills to resolve real-life issues faced by businesses.

**To: travin @ TDI.com**
**From: Vinod**
**Date: 6th Dec. 2012**
**Subject: Restructuring Skyfly Group**

Please find appended herewith the draft analysis on restructuring exercise to be under taken in Skyfly group.

In order to address your requirements mentioned in the previous mail, I have lined up the analysis as below:

1. TOR – (Is not included and to be discussed with you. May be required if we are to use this draft report to produce for the use of Exco. Members of Skyfly )
2. Executive Summary
3. Introduction to Skyfly Group
4. Insight to Global and Domestic trends in aviation Industry
    a. Macro-economic outlook
    b. Industry outlook
    c. Domestic Factors
5. Financial Issues faced by Skyfly
6. Other operational implications of Skyfly
7. Evaluations of recapitalization options
8. Recommendations & Conclusion
9. Other Factors

## Executive Summary

**Skyfly - Company Profile**

- Skyfly is the National carrier in Serendib with a major stake of 51% owned by the government and the balance is owned by Scroon which manages Skyfly.
- It operates its flits to 45 destinations in 23 countries including Europe, Middle East, South Asia, Southeast Asia and Far East. However Skyfly encountered many short sighted strategies.
- Unfavorable Business Climate, Macroeconomic issues and other accumulated financial and operational dilemmas during last decade .

**Current Financial & Operational Issues with - Skyfly**

Skyfly is suffering from continuous losses due to deteriorating revenue, high gearing ratio, poor liquidity. Negative Assets position is reflected in the financial position of the company. Net loss for the last year is 16 Bn. (please refer section five)

In addition to financial problems it faces many operational issues such as threat of losing operational license, threat from oil suppliers, de-motivation of employees, losing pilots etc. (Please refer section six)
All of these suggests going for a strategy change in business model and capital restructuring.

In analysing the global economic trend, industry factors and home country profile, encourage to go for a LCC, from current level, and merging with flying air suggest being a LCC in order to prevent "stuck in the middle" situation. In going for a LCC it has to change all strategies to bring the company to a cost leader.

In evaluating the financing options, the best option would be getting the management service from Asian fly. But this also has some drawbacks. (please refer to section 7)
Hence government should try to get the management from Asian fly while keeping a part of stake with them self.

The other two financing options would not be sound as;

- Bringing additional debt increases the financial leverage and just getting money from IPO would not solve the core issue in Skyfly.
- As Other recommendations, company should solve other operational issues with top priority.

**<u>Introduction to Skyfly</u>**

Skyfly is the national carrier in Serendib country which operates as Full Service Carrier with business and economic class configuration. It operates to destinations in Asia and Europe from its hub air ports at Serendib International Airport.

Skyfly was previously known as Aerofly and it was set up by the government of Serendib in 1982. In the Initial stage it operated three Boeings' 707 and reached six international destinations. It carried 265.000 passengers first year. In its expansion plans government was seeking to alliance with a strategic partner and as a result Aerofly entered in to a Management agreement with Lionfly group in 1998. Subsequently name was changed as Skyfly.

By the years, it increased the original network to a total of 45 destinations in 23 countries with 12 Air buses. It was one of the leading Airlines in Asia with supreme quality including warm hospitality, quality on board and ground followed by a visionary leadership. However the era began from 2000 was very challenging to the group due to the civil war took place in Serendib. Over the last decade, company encountered with high financial and operational risk due to continuous losses, unhealthy financial position, operational inefficiencies and lack of prudent decision making ability shown in challenging environment.

As a result Lionfly divest its strategic management alliance with Skyfly in 2006. Lionfly's stake was acquired by Scroon Airline a Singapore aviation company at a discounted value under the same controlling power.

Nevertheless irrespective the new measures taken by new management to make the airline a profitable and attractive, still Skyfly struggles with the same financial and operational dilemma.

However the subsidiary of Skyfly performs well and it is positioned itself as a **"cash cow**" to the group.

**Insight to global and domestic trends in Aviation Industry**
**Macro Economy**

The below is an insight on future trends, directions and key alarming factors in the aviation industry in terms of macro-economic aspects, industry aspect and inherent domestic factors within Serendib.

To lager extent, these factors drive the future of aviation industry and, hence it is very pre genetic to evaluate the pros and cons of each factor before reaching any strategic decision by Skyfly.

On the other hand these are not the opportunities which could then be matched by existing strengths and converting the threats to opportunities.

**Deteriorating world economic growth**

It is expected world economic growth is likely to slow down to 3% until next decade. As a result people's living standard, savings, par capital might be deteriorated. However **this would be an opportunity to cost leadership business such as low cost carriers in the long run.**

**Developing a strong Middle Class**

Strong middle class has been emerged in China, Latin America, Eastern Europe etc. they would be next drive engine in next century. This **may increase the demand for LCC** which suits to their budget.

**World next Economic Hubs – BRICS**

Brazil, Russia, China, South Africa would be next world economic hubs who drives the world economy. Most of these countries are located in Asian region. Since these regions promote their best MICE (Meetings+Incentives+Conference+Events), air travelling across these regions would be frequent in future.

Hence having **an air travel solution which minimizes the cost leakage is highly essential** in the next decade.

**How the industry will move in Aviation Industry**

**Increasing global LCC Share**

Global LCC share has been increased over last decade from 7.8% to 22% in the last ten years.

**Competition from rivals**

- ✓ Intense competition could be seen among rivals and this has led to severe price cuttings, mega marketing, promotions, and mergers acquisitions etc.
- ✓ Demand for new high fuel efficient aircraft also have been increased. More than 12000 orders have been made for Boeing and Airbus for next two years.
- ✓ High LCC market penetration in Asia
- ✓ Market penetration in Asia for LCC is 46.4% and this is the highest among other regions.
- ✓ Continued losses by major premium airlines in the West Europe, specifically FSC segment. However, many leading LCC continued to generate profits from their operations.

**International Travelling Movement**

In bound tourism arrivals in Asia is strengthen by 85% increase in the year 2010 compare to arrivals in 2000. South Asian segment also shows a high growth.
Hence it shows the potential for growth in Aviation Industry.
There is an Increase in inbound tourist arrivals in Serendib. This is a 30% increase over the previous year.

**Financial Implication & Skyfly Airline – Snapshot**

- Group revenue increased by 6% to 75 Bn in 2012. However, passenger revenue in 2012 has been decreased to 59Mn from 66Mn in 2008.
- Operating expenditure has been increased by 13% to 90 Bn in 2012 over 79Bn in 2011. While staff cost accounts for 12% of total operating cost, the annual operating lease accounts for 9%.
- Continuous losses
  - No profits attributable to equity holders over last 10 years except year 2007/08. Company recorded a net loss of 16 Mn in 2012, compare to 8.9 Mn in previous year.
- Negative net assets has been reached to 12 Bn in 2012
- High financial risk through high gearing ratio of 70%
- Severe working capital problems through increasing negative net current assets. Working capital deficit has been increased to 15Bn in 2011/12 while the deficit for 2010/11 was 12Bn.
- Benchmarking with 2007/08 performance
  - In analyzing the 2007/08 financial data, it appears that maintaining a 3% markup would be enough to sustain the company as a profitable one.

**Other Operational Implications of Skyfly**

- Possible threat of losing operating license and contracts with airports due to large outstanding balances to airports.
  If those airports suspend the landing slots to Skyfly, it affects the going concern of the business. And company has to pay additional money to get the license with penalties.
- Possibility to cancel the fuel supply for Skyfly due to large arrears to fuel companies.
- Losing many pilots & Key technical staff
- Unionized actions by de-motivated employees.
  - No salary increments, bonus and incentives have been created unrest among employees and given rise to few union actions.
  - This has brought many financial losses to group.
  - And this has harmed the company image too.
- Number of aircrafts in service has been reduced.
  - Aircrafts in service at the yearend 2011 has been dropped to 10 from 12.
  - This could be a reason of shutting down existing routes, less demand and etc.
  - Following to sale and lease transaction in 2010, only one aircraft is owned by Skyfly.
- More frequent flights cancellations and routes cancellation
  These cancellations disturb the continuous flowing of business and might interrupt the brand image with skyfly.
- Loss of reputation
  - Many passengers and tour operators keep avoiding the Skyfly now.
  - This shows the bad image with Skyfly across the Skies.
  - Poor quality in service might be the main reason behind this.

- Higher rate of employee per aircraft ratio
  - Employee per aircraft ratio is 420 while industry benchmark is 100.

    - As per current financial analysis, the company could easily save around 9Bn, if the company is par with Industry benchmark.
- Reducing passenger load factor from 54% to 50% in 2011.\
    - Industry average is 78%.
    - However Skyfly's breakeven load factor is at 80%.
    - This will show the seat utilization over the availability and management may notices how far behind the occupancy of Skyfly.
- Lack of Visionary Leadership
    - Management has not showcased prudent decision making strategies in the company's challenging periods.
- Unit cost has been doubled to 52.25 (SR T Km) over 27.3 SR t km in 200.
- Lack of transparency showed in some transactions entered by Skyfly.
    - How the management has used sale proceed in sale/lease transaction is not apparent. The decision is not deemed to be prudent.
- Negative growth rate in revenue passenger capacity.
- Losing Skyfly's market share in Serendib.
    - Compare to last year, it has been dropped by 6% and the losing market share has been grabbed by other competitors such as S.I.A, Emirates…etc...

**<u>Evaluating the Re-capitalization options</u>**

Many financials and operating issues which are faced by Skyfly do affect the long run survival of the airline. Hence executing the financial strategy should focus on the macro factors, industry factors and other implications in the Skyfly.

Re-capitalizations options should be in line with the other operating strategies of the Skyfly. Hence before analysing on which financing option Skyfly should undertake, it should decide what kind of operational re-structure is required to carry the business.

Just infusing capital may not resolve the current problems. In analysing the macro factors, industry factors and home country supporting factors (which we have explained in No. 04 under the caption insight to global and domestic trend in Aviation Industry), it is convinced that the future demand and trend for air travel is more with low cost carriers.

Hence, whether we are successful in FSC segment in the future is doubtful.
Further in the proposed merger with Flyingair, what kind of operational model that post-merger entity is operating should be pre-decided?

Currently;

| | |
|---|---|
| FlyingAir, | Low cost Carrier |
| Skyfly | Full Cost /Service Carrier |

If the merged entities operate in a hybrid model, (i.e. both entities run their current operations model separately in the same entity as two business segments) this may be ended up with "stuck in the middle situation". On the other hand there can be cannibalizing effects among two segments. Hence both entities should convert to a one model is very much important in order to be the merger successful in the short/medium and long run.

However, due to current bad business experience it may not be able to cater a differentiated service (a premium carrier). And further the environmental factors may not supportive to the premium service carriers in the long run.

Therefore, the possible option is going for a LCC. In a case where it converts to LCC, being alliance with an industry giant would be generating synergetic effects.

Asianfly is the industry giant, expert in the LCC industry. As per the part experience, government may not showcase the same expertise as Asianfly in LCC segment.

In this context, in analyzing the best capital re-construction option out of

Long term borrowing
Asianfly investment
Skyfly catering – IPO,

The second option of getting Asianfly's investment supersedes/overweigh the others.
Let's we analyse three options separately.

Option (A) - **Long Term borrowings**

- In comparing two banks, the local bank, loan period is higher than the foreign bank.
- However, due to current financial problems, re-paying 50Bn in 4 Years time is not practicable.
- In analysing the interest rates, it has to **get an idea what the current AWPLR is?**
- Pledging a security/ Mortgage bond would not be a difficult tasks as government can intervene in pledging the security (specially with a local bank).
- But, getting a **loan increase the gearing ratio further high and make the company high financial leverage one**.
- Further, **committing a continuous interest payment plus the disbursement would be a difficult task among the current financial issues**.
- Also, **getting just bank loan would not solve the problems and as per the current situation, no assurance can be given that capital infusion is just itself recover the other operational issues and make the airline profitable**.
- Owing to the significance of the above, it is concluded **that borrowing is not a viable solution**.

We have not separately quantified the impact of further borrowings, as it is obvious that it would definitely increase gearing ratios as a result of increase in borrowing cost/ finance cost…also increase in debt as against equity.

Option B – **Asianfly as an Investor**

**Advantages of Joining Asiafly:**

- No need to invest for fleet. Asianfly has a large fleet and they can be used in the operations and reduce the capital outlay.
- Expert management skills
- Getting landing slots would not be difficult as Asianfly has a high bargaining power.
- Successful history with merging acquiring franchising with other airlines. E.g. Thai Asianfly, Fly Y etc…
- Getting experience and lessons on how to reduce the cost as they are the cost leader. Since LCC is mainly driven on cost leadership strategies, and currently Skyfly cost is too high to accommodate to LCC, definitely it is needed to reduce the cost dramatically.
- Economies of scale can be achieved through bulk purchase, collective marketing, code sharing
- Excess staff of skyfly can be transferred to Asianfly
- Good Leadership and management can be expected to manage Skyfly.

**Whether to sell catering arm to Asianfly is feasible?**

Skyfly catering is a lucrative business. And it has high growing potentials due to;

- Long term contract till 2020 to serve to major airlines
- Strong credentials
- Strong customer base
- Profitable diversification to laundry and other hotelier services etc...

This shows the future potential of Skyfly. Apparently government has been doing the business well. Therefore, there is no need to have structural change to Skyfly catering company.
The core issue is with the airline. Therefore, acquiring catering segment by Asianfly would not solve the current issues with Skyfly.

Owing to the significance of above described **disadvantages of selling catering arm to Assianfly, we have not computed the minimum price to be received by selling catering arm**. However, based on available financial information of Skyfly catering, currently its (Catering Company) net assets worth is Rs. 4933 Mn. So valuation starts bare minimum at 5 Bn. This is not appropriate at all to match the financial need of Skyfly…

**Possibility of selling more than 50% of the stake with management**

Definitely management should be changed. However, in selling government stake, many other negative implications may arise.

- Losing the control over the company
- Can be a threat or risk to a national security
- Losing the image of being the national carrier
- Repatriation the profit from Serendib
- Asianfly may acquire its stake at a discount value due to current issues with Skyfly
- Protest from Union

**Option C – IPO**

As Skyfly Catering is successful from its inception with continues profits, there is a possibility of going for an IPO by listing. But, as mentioned earlier, just obtaining fund infusion may not solve the problems with Skyfly.

However, it is required to consider legal and ethical aspects too

- Would the Serendib Stock exchange rules allow a subsidiary company to raise capital through IPO to a loss making parent?
  This is a very critical question that the company should consider in analyzing possibility of going for IPO. Raising money through an IPO by a subsidiary to fund its parent company will be a violation of regulatory requirement.
- Would new investor just invest with Catering Company without looking at prospects of its parents? Or would the investors just accept the IPO to fund loss making parent… without looking at future return from the investment.

**Conclusions & Recommendations**
As per the above analysis and pros & cons with each option, it is concluded that going for **a change in the business model** of Skyfly would be the best solution to protect the airline.

Therefore, analyzing the environmental factors and proposed merger with flyingair - a budget carrier, it **is recommended to go for a LCC model**.

In capital restructuring, the best possible option would be getting the foreign institutional investor with the management. Joining with Asianfly would be the best option. However, there are some negative implications as well.
In this context, government should decide structure by considering those aspects.

**<u>Other recommendations</u>**

- ✓ Prioritize to solve the working capital problems
  - o In order to prevent a liquidation situation due to cancelling landing rights, oil Supply Company, may priority to settle those.
- ✓ Execute an action plan to replace more capable pilots & officers.
- ✓ Implement an execution plan to reduce the operating cost
- ✓ Redundancy plan to save approximately 9 bn paid to excess staff.
- ✓ Implement a hedging plan to cover the Skyrocketing oil prices
- ✓ Maintain high operational efficiency.
  - o High aircraft utilization is crucial to maximize the profits of airline.
- ✓ Quick turnaround strategy is required to maintain high passenger load factor to spread fixed cost.
- ✓ Implement a robust internal control system while carrying out management audits and internal audits. This may reveal the inefficiencies misappropriations and remedial actions.
- ✓ Implement a CEO succession plan
  - o A necessity of a visionary leader who is capable to foresee the industry future is very much pragmatic.
- ✓ Remedial actions to increase revenue through high yields, high load factors--- enhance quality on board, quality on interiors and efficiency in ground handling
- ✓ Optimize the best fleet management style which covers,
  - o Identifying appropriate aircrafts type for route network
  - o Identify extent of ownership and leasing for optimum strategic objectives.
  - o Acquire appropriate fleet to meet current planned network requirements
  - o Optimize leasing arrangements
  - o Maximize profitability per aircrafts

- ✓ Implement customer satisfaction programme
- ✓ Implement brand awareness programme
- ✓ Implement strategic approach to personal issues position “low cost airline mentality among employees… and carefully plan out the redundancy plan
- ✓ Implement a change management strategy
- ✓ Implement a stakeholder mapping exercise to identify the most valuable stakeholders, key players and satisfy them

**Other factors to be considered in restructuring plan**

- ➢ 49% stake with current management Scroon Airline
  - o In the proposed restructure to change the management it is important to get Sroon’s consent
- ➢ In the proposed conversion, the current revenue from long haul segment – 25% of total income might get affected
- ➢ Possible revenue loss from Skyfly airline by its subsidiary, if Skyfly converts to a LCC
- ➢ In proposed restructure to a LCC, there can be a hit to catering segment as budget carriers don’t serve free meals. Currently 50% of the revenue of catering is coming from Skyfly.

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