UNIVERSITY OF JOHANNESBURG

Department of Accountancy

Financial Management 300

FINAL ASSESSMENT OPPORTUNITY 11 NOVEMBER 2017

Time: 4.5 hours **Marks: 150**

(45 minutes of reading time and 3 hours and 45 minutes of writing time)

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INSTRUCTIONS:

- This paper consists of 11 pages.
- Answer ALL questions.
- Start each question in a new book (in the correct colour book please).
- Silent, non-programmable calculators may be used, unless otherwise instructed.
- Show all calculations clearly. Round all calculations to two decimal places.
- Answer in the following colour books: **Q1 = Blue; Q2 = Green; Q3 = Red**

QUESTION 1 **(55 MARKS)**

Edcon Holdings (Proprietary) Ltd. (Edcon) is a non-food retailer based in South Africa. The company offers a comprehensive range of private label and national branded merchandise under the Edgars, Jet, CNA, Boardmans, Red Square, DiSCOM and Legit trade names. Its product offerings include clothing, footwear, textiles, cosmetics, mobile phones, stationery and books. Apart from this, the company offers credit and financing services to its customers. Majority of the company stores are located in key locations such as shopping malls, city centers and high streets in South Africa, Botswana, Namibia, Swaziland, Lesotho, Mozambique and Zambia.

Edcon's business was booming in the early 2000s. Sales growth hit a record high of 15.50% in September 2006 and averaged about 12% per annum from 2004 to 2007, however, the retail picture has since deteriorated. Edcon fell into serious difficulty, which culminated in a debt-to-equity-deal in 2016. Reorganising the South African retailer's complex and highly leveraged capital structure[1] was challenging. This reorganisation resulted in Edcon having to enter into negotiations with banks, trade creditors and other debt providers to convert their debt into equity. This was required in order to keep Edcon solvent. Edcon's ZAR19.7 billion ($1.5 billion) debt restructuring was the first major leveraged buyout (LBO) restructuring in South Africa.

On 15 January 2016 the Edcon Group conducted the Sale of Legit. Edcon agreed to the sale of Legit for a R725 million (the "Legit Sale") profit to Retailability Proprietary Limited, a retail fashion holding company which operates over 200 stores across South Africa, Namibia and Botswana (including the Beaver Canoe and Style chains) and, in which Metier Private Equity is a material shareholder. This Group believes that the Legit sale is aligned with Edcon's strategic drive to create a simpler, more agile business that is focused on carefully selected offerings in which the Group believes it can add significant value.

The newly appointed chairman of Edcon said the retailer was too important to fail and would be turned around. Mr Gareth Penny, the former group CEO of De Beers and now chairman of Edcon, said Edcon, which is the largest clothing retailer in SA, had 45,000 employees, 9 059 634 registered Thank-U card customers in 2016, and was a major player in local malls with 1,542 retail outlets. The number of retail outlets has decreased by 335 across all of the Edcon brands in the current financial year (inclusive of the Legit stores) where as the number of customers Thank-U cards in 2015 was 8 850 234. Customers can register with Thank-U cards free of charge and the cards do not expire.

Edcon is arguably the leading non-food retailer in South Africa. This group also has the advantage of being able to penetrate customer markers with a combination of sales channels. Strong Revenue

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[1] Highly leveraged capital structure: This relates to the high percentage of debt funding utilised by Edcon in comparison to equity. This is an indication of financial risk, which means that the company may not be able to settle all of the capital repayments and interest payable to financial institutions and banks.

Growth in Retail Business have however been diminished by the high cost of debt that the company was buckling under.

Edcon purchase approximately 58.6% of their products directly from markets outside of South Africa denominated in a foreign currency, principally in Asia, and the number of their foreign suppliers may increase as they proceed with their strategy to partner with suppliers in countries with low production costs. This exposure has had significant negative effects on the profitability of Edcon.

The rise in inflation in South Africa, increased pressure from competitors and the high seasonality of Edcon's major business operations have also played a significant role in Edcon's lack of profitability.

Consolidated Statement of Comprehensive Income of Edcon Holdings Limited	**Notes**	**31 March 2016 Rm**	**31 March 2015 Rm**
Total revenues	1	**27 147**	28 257
Cost of sales		**(17 173)**	(17 265)
Gross profit		**9 974**	10 992
Other income		**1 416**	1 256
Store costs		**(6 463)**	(6 277)
Other operating costs		**(4 665)**	(4 666)
Profit on disposal of Legit		**725**	-
Trading profit		**987**	1 305
Derivative gain/(loss)		**743**	(601)
Foreign exchange (loss)/gain		**(374)**	943
Fair value adjustment for put option		**23**	(6)
Impairment of brands and goodwill		(4 871)	0
(Loss)/profit before net financing costs		**(3 492)**	1 641
Finance income		**64**	33
(Loss)/profit before financing costs		**(3 428)**	1 674
Financing costs		**(4 272)**	(3 414)
Loss before taxation		**(7 700)**	(1 740)
Taxation		**(335)**	(243)
LOSS FOR THE PERIOD		**(8 035)**	(1 983)

Note 1: Segmental Report

The Group is organised into business units based on their target markets and product offerings. The four main business units are Edgars, Discount (Jet, DiSCOM & Legit), CNA and Edgars Zimbabwe as these business units target different domains of income, age and products. The segmental report in addition, also reports on geographical performance and group services costs to further assess performance.

	Note	REVENUE		(LOSS)/PROFIT BEFORE NET FINANCING COSTS	
		2016 Rm	**2015 Rm**	**2016 Rm**	2015 Rm
Edgars division		**13 929**	13 929	**962**	1 305
CNA division		**1 867**	2 011	**31**	35
Discount division		**10 529**	10 771	**1 010**	1 220
Edgars Zimbabwe division		**822**	799	**110**	101
Group Services Costs	**2**	**0**	0	**(5 605)**	(1,020)
Group Total		**27 147**	27 510	**(3 492)**	1 641
Geographical break-down					
South Africa (including Zimbabwe)		**23 896**	24 255	**(3 691)**	1 293
Other 8 Countries	**3**	**3 251**	3 255	**199**	348
Group Total		**27 174**	27 510	**(3 492)**	1 641

In an attempt to remain financially viable, Edcon has increased clearance mark-downs in particularly the Edgars division over the past two years. Edcon imports most of their merchandise and is affected by any changes in the value of the local currency.

Note 2

Incorporating corporate divisions and consolidation adjustments, including additional depreciation and amortisation which arose on formation of the Group.

Note 3

Comprising Botswana, Lesotho, Swaziland, Namibia, Zambia, Mozambique, Ghana and Zimbabwe

General Information

According to Statistics South Africa (StatsSA), the consumer price inflation was 6.53% for the 12 month period ended 31 March 2016. The value of the Rand also devalued by 20% to the US Dollar during the same year.

Subsequent events
Edcon swung into a trading profit in the first quarter of 2017 despite a deterioration of the operating environment.

Mr BJ Brookes, the CEO made the following statements with regards to the improved performance:

- "Our strategic repositioning and transformation process has started indicating the green shoots of change"
- "Edgars and Jet delivered better customer service in stores, experienced an improvement in retail sales performance and there was excellent cost containment throughout Edcon"

In the first quarter ended 24 June, Edcon's trading profit jumped 165.4%, to R89m, from a loss of R136m. Overall same-store sales fell 1.4%, but the group's main chain, Edgars, reported an increase in like-for-like sales of 1.6%, which is an indication that on-line sales have increased during the quarter under review. Edcon's first-quarter results follow on the heels of Truworths' full-year results. As far as the trading environment was concerned, the two retailers painted a grim picture but were hopeful of a change in fortunes in the year ahead.

Analysts who assessed the performance of Edcon up to date reported the following:

- The current board of directors has limited retail experience but has significant experience in corporate finance.
- Moneyweb reported on 26 May 2017 that the ex-Massmart chief, Grant Pattison, would replace outgoing CEO Bernie Brookes in February 2018[2]. *"Restoring Edcon to its former glory is a privilege and a challenge. I'm excited about the challenge of restoring it to being the best retailer in South Africa,"* said Pattison.
- Business media analysts had identified that CNA was an ailing part of the business as performance had significantly decreased. Brookes said plans are afoot to consolidate brand product categories at CNA. "It was fiddling in too many categories such as digital, gifting, and electronics," he said.
- During 2017 existing Edcon store sales were being cannibalized by the opening of additional Edcon stores in new malls such as the Mall of Africa. New competitors such as Zara and H&M has also resulted in further sales growth pressure. Average retail space per store had grown by 6% to 8% over the last five years and is placing increased cost pressure on Edcon.
- The IT systems used across all point of sale systems and merchandise management systems in the Group are aged and inefficient. These are critical to the efficient operations of Edcon. The aging IT systems are causing reduced productivity.
- Edcon is highly dependent on key personnel who have expertise in and knowledge of the industry. In addition, the business faces strong competition in attracting and retaining qualified managers and employees.

[2] https://www.moneyweb.co.za/news/companies-and-deals/renewed-hope-for-edcons-recovery-plan/

QUESTION 2 **(55 MARKS)**

Foodcorp Ltd ('Foodcorp') is a foodservice company with its head office in Sandton, Johannesburg. The company serves a wide range of restaurants and fast food outlets in South Africa. It was incorporated in 1995 and was acquired by Midvest plc in 1998 when it became a food service business unit of the Midvest group. In the first half of the calendar year 2016, Foodcorp was listed on the JSE after a successful unbundling exercise by Midvest.

Foodcorp is transforming its business by adapting a "direct-to-customer" model whereby it acquires independent customer facing businesses with higher margins.

To achieve Foodcorp's strategic goals, management is currently working on 2 key projects. One project is an acquisition of a Durban based foodservice business called NatalFoods (Pty) Ltd **('NtF').** Another project involves an upgrade to one of the current food facilities in Johannesburg.

Investment opportunity 1: Acquisition of NtF

NtF was established in 2005 by Mr Darshen Patel, an experienced tourism and hospitality professional who is also the current CEO of NtF. Mr Patel now holds 30% in the company and the rest is held by two institutional investors. The company has predominantly served clients in Durban, but during the past year they opened a branch in Mbombela, Mpumalanga, which, although taking time to enter the market, has tremendous potential for growth in sales and profit to the business. The company has a great track record of delivering excellent service to clients and is well known for its advanced food technology systems. With its technology, NtF has accumulated customer data that is useful in identifying emerging business trends in the food service industry as well as customer loyalty levels to specific restaurant brands. The company would like to open more branches but is short of cash resources and neither Mr Patel nor the two institutional investors are able to provide the necessary capital injection in the business. Furthermore, Mr Patel will retire soon as he is already 63 years old. The two institutional investors have tried to sell their share in the business for the past 18 months, but there was very little interest from potential buyers.

Negotiations are already underway for Foodcorp to acquire a 70% equity stake from the institutional investors and Foodcorp has signed non-disclosure agreements in which it committed to pay an administration fee if it fails to conclude the acquisition transaction.

Extract from the audited Income Statement of NtF for the year ended 30 September 2017

	Notes	2017 R'000	2016 R'000
Revenue	1	131 248	126 783
Cost of revenue		(103 181)	(99 671)
Gross profit		28 067	27 112
Other income	2	6 290	4 520
Operating expenses	3	(13 940)	(13 549)
Finance charges	4	(1 015)	(1 219)
Profit before tax		19 402	16 864
Taxation	5	(5 432)	(4 722)
Profit for the period		**13 970**	**12 142**

Notes

1. Revenue for the year had been budgeted to be higher than R131m but in late April 2017, the company's main facility in Durban was closed to cater for renovation and expansion. The project was meant to accommodate high expected demand from local restaurants and hotels who cater for the racing fans gathering for the Vodacom Durban July. However, the contactor who was hired for the job missed project time lines due to their employees striking. The sales lost due to the facility closure was reliably estimated at R5 600 000. Assume a constant gross profit percentage on sales. NtF took the contractor to court to claim compensation – ***refer note 2 below.***

2. Other income is made up of

    - Rental income on a building located in Bloemfontein that is owned by NtF. The building was acquired in 2010 with the intention of opening a restaurant in Bloemfontein. However, the expected market demand did not materialise and the building has since been converted into an office building, which is rented out to local small businesses. The building generated rental income of R2 840 000 in the 2017 financial year and the rental contract provides for a 3% annual increase, which is regarded as a sustainable increase for the future. The required rate of return for office buildings is 12%.

    - R3 450 000 is a once-off amount recovered by NtF after a successful lawsuit against the contractor who was hired to renovate and expand the food centre in April 2017 but failed to complete the project on time – ***see note 1 above.***

3. Included in the operating expenses is Mr Patel's annual salary (cost to company) of R1 600 000. Mr Patel has indicated that he will be resigning as the CEO of NtF but will be retaining his 30% equity stake in the company. Foodcorp needs to employ a Regional Managing Director to replace Mr Patel but the potential candidate insists on a cost to company salary of R2 000 000.

4. Finance charges were incurred on a long-term bank loan which incurred interest at a market-related charge rate of 10.65%. This interest rate remained constant during the past 12 months, and the loan amount also remained constant for the past 12 months.

5. Market data for similar foodservice companies listed on the JSE is presented below:

Company	**Historic multiple (EBIT)**	**Market capitalisation**
		R'000
FoodWorld	7.9	119 362
Inkomo	8.4	160 313
Dijong Ltd	6.7	130 824
Blover Industries Ltd	21.0	32 536

Investment opportunity 2: Gauteng foodservice facility upgrade

Foodcorp currently outsources most of its food freezing requirements to an external company. Management had plans to invest in new food freezing equipment for its facility that has a larger capacity to cater for the higher demand. However, the investment appraisal performed yielded a **negative Net Present Value (NPV) of R1.683 million** and management are looking further for solutions to this investment case.

The equipment has an economic life of 10 years. The equipment would be supplied by ColCab Ltd at a purchase price of R17.5 million and installation costs of R200 000. Annual maintenance and insurance costs amount to R400 000. ColCab Ltd has facilitated a meeting between its strategic finance partner, Afrimerge Group, and Foodcorp. Afrimerge Group has a specialist asset finance and insurance solutions division. The division has proposed the following to Foodcorp:

> A 5-year lease where Foodcorp pays R3 million in advance annually as lease payments and a final purchase price of R5 million at the end of the lease term, which will also be considered to be the reasonable value by SARS. Afrimerge Group will be liable for maintenance and insurance for 5 years and will also carry the installation costs.

Additional information:

- The company tax rate is 28%.
- SARS allows tax deductions over 5 years to the owner of the equipment.
- The estimated re-sale value of the equipment after 5 years is R2 000 000.
- Pre-tax cost of debt for Foodcorp is 11.3%
- Ignore VAT.

QUESTION 3 **(40 MARKS)**

PART A

Cutifani and Co. (Pty) Ltd (hereafter the 'company' or 'C&C') is a South African (hereafter SA) company. C&C was founded in 1983 by brothers Mark and Steven. The company is the leading SA manufacturer of Electronic Bedside Clocks. C&C initially operated using a functional organisational structure, but has for the last decade operated using a divisionalised organisational structure whereby divisions are fully autonomous. The company consists of two separate divisions. The Clock Division, which produces proudly SA Clocks, while the Retail Division has evolved into a retailer of a wide variety of electronic devices.

As a management accounting consultant, you have been requested to assist the newly appointed accountant of the Clock Division in preparing and analysing the budgeted information related to the 2018 financial year. The accountant has provided you with the following draft budgeted statement of income and expenses, as well as the notes as set out below.

Draft Budgeted Statement of Income and Expenses of the Clock Division for the period ended 30 November 2018		**Notes**
Sales	5 840 000	**1**
Cost of sales	?	**2 – 7**
Gross profit	?	
Distribution expenses	191 000	**8**
Administration expenses	28 000	**8**
NET PROFIT	**?**	

Notes:

1. During the year ending 30 November 2018, the Clock Division expects to sell 73 000 clocks. The division's expected production to be achieved on average over a number of periods, taking into account the loss of capacity resulting from planned maintenance is 70 000 clocks.

2. During the 2017 year end 60 000 clocks were produced. Furthermore, as at 30 November 2017, inventory on hand consisted of 15 000 completed clocks. Finished goods inventory is measured at standard cost.

3. Closing inventory as at 30 November 2018 is expected to consist of 8 000 completed clocks.

4. For the 2017 year end, there was an adverse material input variance of R264 000. The 2018 budget should be updated to reflect the new material standard. In addition, the analysis of the material costs and inputs for the 2017 year end also revealed the following:

- The standard cost of input material was R10 per kilogram.
- Each clock required 2.2 kg of material input.
- No usage variance was anticipated.

5. The division uses skilled labourers to produce clocks. There are currently 8 labourers who are paid R30 per hour. On average, they can each produce one clock in 9 minutes. Labour has been identified by the division as a major capacity constraint.
6. Production in 2017 resulted in an over-allocation of R30 000 for fixed manufacturing overheads, while variable overheads amounted to R480 000 for the 2017 year end. Variable manufacturing overheads vary per clock, whilst fixed overheads are absorbed on the same basis.
7. The cost structure per clock for 2018 is budgeted to remain unchanged from the 2017 year end, barring the material cost.
8. In preparing the abovementioned report to management, the accountant determined that if 68 220 clocks had been sold during the year, distribution costs would have been 181 450, while administration costs would have remained unchanged.

PART B

New market information

Before approval of the Clock Division's budget for the 2018 financial year, important new information came to light. Due to changing market conditions, the entity now expects that it may be able to charge higher prices than in the past and accordingly is considering a strategic decision to increase their production capacity. They have determined that they would be able to increase their labour capacity to enable production of 95 000 clocks in the short term. The increase in capacity will only require bringing in a number of new labourers and is not expected to further affect the cost structure as used to prepare the initial 2018 budget above.

It has been determined that demand for clocks is still fairly price elastic, and demand levels at various price points have been determined as follows:

Selling Price (R)	80.00	95.00	110.00
Demand level (Clocks)	95 000	90 000	70 000

Request from Retail Division for transfer of clocks

The Retail Division has approached the Clock Division with a request to supply them with 7 500 modified clocks in the forthcoming year. The Retail Division would like to introduce this new line of clocks for sale to students who use them to write tests and exams. The modified clocks will undergo exactly the same manufacturing process as regular clocks, but will need to be modified slightly by the Clock Division's labourers in order to meet the requirements of the Retail Division. This modification will require an extra minute of labour time per clock produced for this purpose. The Clock Division will not incur any distribution costs on the 7 500 clocks transferred to the Retail Division.

The Retail Division will then outsource the clocks for further processing at a cost of R30 per clock in order to produce its customer’s desired product. The Retail Division does not currently sell such modified clocks in its retail stores. The modified clocks are expected to sell at R120 per clock.

The Clocks Division prides itself on its ability to always exceed its customer’s expectations and has never suffered from a stock-out situation. It has even gone so far as to publicly state that if it should ever fail to satisfy demand from their regular customers, they will donate R18 000 to a local charity as a gesture of goodwill.

The managers of the two divisions have agreed with top management should the transfer of any clocks take place that the negotiated transfer price method would apply. This means that both a minimum and maximum price needs to be calculated for each proposed transfer.

Currently, there are no transfer of products taking place between the divisions.

Assume today is the 30th of November 2017.

REQUIRED

QUESTION 1 **(55 MARKS)**

REQUIRED		**MARKS**
(a)	Analyse and discuss the financial performance of Edcon for the 2016 financial year. Consider the impact of subsequent events on your analysis where applicable - *18 Marks: Revenue* - *5 Marks: Gross Profit* - *10 Marks: Trading Profit*	33
(b)	Explain how Edcon can utilise put options to manage liquidity risk?	2
(c)	Identify the risks that Edcon face and describe factors/strategies to mitigate these identified risks.	20
TOTAL MARKS		**55**

QUESTION 2 **(55 MARKS)**

REQUIRED		**MARKS**
(a)	Perform a valuation of the 70% of the ordinary shares of Ntf (Pty) Ltd at 30 September 2017 on behalf of Foodcorp Ltd. Outline all your considerations and your key assumptions.	35
(b)	(i) Evaluate the project finance options proposed by the Afrimerge Group and advise whether Foodcorp should invest in the new food freezing equipment.	15
	(ii) Briefly discuss other factors that Foodcorp needs to consider when evaluating the Afrimerge Group proposal regarding financing the project	5
TOTAL MARKS		**55**

QUESTION 3 **40 Marks**

REQUIRED:		**MARKS**
	PART A	
(a)	Using the original draft budgeted statement of income and expenses of the Clock Division for the 2018 year, calculate the budgeted cost of sales.	10
	PART B	
(b)	Taking into account the new market information that has come to light, and assuming the entity does increase its capacity as discussed, determine the minimum and maximum price calculated by the managers of the Clock and Retail Division respectively, and conclude on the final transfer price. Assume the following cost structure information (per clock) for the Clock Division: - Material R26.40 - Labour R 4.50 - Variable manufacturing overheads R 8.00 - Variable distribution expenses R ? - Fixed manufacturing overheads R 3.00	22
(c)	Discuss any other factors the Clock Division should consider before accepting the request from the Retail Division.	4
(d)	Discuss the objectives of a sound transfer pricing system in light of the above calculations.	4