Department of Accountancy

Financial Management 300/BCTA

FINAL ASSESSMENT OPPORTUNITY

15 November 2019

Time: 3 hours & 45 minutes (37 min. reading time and 188 min. writing time) **Marks: 125**

Assessors: Mr T Madiba
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INSTRUCTIONS:

- This paper consists of **12** pages.
- Answer ALL **3** questions.
- Start each question on a new answer book.
- Silent, non-programmable calculators may be used, unless otherwise instructed.
- Show all calculations clearly. Round all calculations to two decimal places.
- **PLEASE WRITE YOUR EXAM NUMBER ON ALL ANSWER BOOKS.**

PLEASE ANSWER IN THE FOLLOWING COLOUR ANSWER BOOKS
Q1 = BLUE **Q2 = GREEN** **Q3 = RED**

QUESTION 1 (BLUE ANSWER BOOK) (45 MARKS)

The Divercity investment group's main strategic goal is to combine commercial buildings with affordable residential accommodation to create inclusive and diverse neighbourhoods.

Divercity's main project for this year will be the Jewel City redevelopment project in Johannesburg. Jewel City is located in the eastern CBD of Johannesburg, on Fox Street, placed between Maboneng and Absa precincts. The redevelopment will consist of six city blocks, five of which have existing commercial buildings on them.

By remodelling Jewel City's existing buildings and constructing new buildings of over 40,000sqm, Divercity will be converting a formerly closed-off area of the city into a thriving, modern inner-city neighbourhood. Jewel City will reopen to the public in 2022 as a mixed-use precinct, including 2,200 new residential apartments.

The project is expected to have a total development value of more than R300 million upon completion.

The City of Johannesburg council has in principle approved the rezoning of the Jewel City precinct owned by Divercity, for residential development. The fee to finalise the rezoning application of the property from industrial use to residential use would amount to R250,000. Divercity is considering the possibility of developing residential apartment blocks, in which units will initially be leased out. Each unit in the residential apartment blocks will be similar in terms of size and layout. Divercity has already enlisted the services of an architect who drew up plans for the proposed development. The architect was paid for her services in June 2019.

Divercity has been in negotiations with a contractor to develop the residential property. The contractor will commence work after the existing buildings have been demolished. The scope of the contractors work will include all relevant earthworks, infrastructure development and' construction of the residential units. The development will take two years to complete, and the contractor will require payments as follows:

- 40% of the total development contract fee upfront;
- 35% on the completion of certain milestones after one year; and
- the balance upon completion of the development at the end of year 2.

Once the project is completed after two years, Divercity plans to let the units, at 100% occupancy, for three years, and thereafter sell the entire apartment block as a going concern.

Divercity is in the process of finalising an agreement with Prestige Minerals, a major commercial diamond dealer based in Jewel City, to place logos and advertisements on the exterior of the highly visible property boundary fence during the two-year construction phase. Prestige Minerals is very excited about the opportunity, for these advertisements would be seen by motorists on the busy M2 freeway and would thus give their group enormous exposure.

In the past Prestige Minerals leased their showrooms from Divercity however one of the showrooms' geyser was faulty causing the showroom to flood. Divercity has informed Precious Metals that the advertising rates will be lower than market rates in order to compensate Precious Metals for this unfortunate incident. Market rates for similar advertising would amount to R2,500,000 per annum, but Precious Metals will pay 75% of the market rate for this advertising opportunity.

After doing extensive research into the planned residential property development, Divercity, with the assistance of Mr Jorik Joubert, an experienced property valuer, determined that the fair value of the property would be R300 million if it were to pursue the opportunity. The valuation committee of Divercity questioned the R300 million fair value of the residential development and its significant difference from the current fair value of the investment property of R200 million. Joubert prepared detailed forecasts relating to the residential development project for presentation to the valuation committee. The board of directors of Divercity asked that this information be summarised into a capital budget to assist the board with its evaluation of the proposed project. Details of the project's forecasted revenue and costs, together with other relevant information, are summarised in the table below:

Total development contract fee	R550 000 000
Architect fee (drawing up of plans)	R1 000 000
Cost to demolish the warehouses and shops prior to commencement of development	R3 000 000
Total units in estate	2 200
Expected rental income per unit	R16 000 per month in the first year of renting the units, with an escalation of 6% per year. Rental income will be due and payable in arrears.
Estimated occupancy of residential units after completion	50% in year 1 100% in year 2 and 3
Earnings before interest, tax, depreciation and amortisation (EBITDA) margin on the Jewel City redevelopment project.	61% of rental income
Tax rate	28%
Expected selling price of the fully developed and 100% occupied residential estate at the end of year 5	R780 000 000
Transaction costs to sell the estate (agent commissions and legal fees) at the end of year 5	R15 000 000

Beta coefficient of Summercon, a company which owns and lets residential property and is listed on the Johannesburg Stock Exchange. Summercon has a market capitalisation of R900 million	1.3
Average ten-year government bond yield	8.3%
Market risk premium	6%
Estimated fair value of 100% of the ordinary shares of Divercity	R1 billion

The only permanent debt financing utilised by Divercity are the bank loans with a fair value of R3 billion which bear interest at a market-related rate of 9,5% per annum. The residential property development will be funded out of the surplus cash to be generated by the Divercity group over the next three years.

Divercity will qualify for a section 13 sec tax deduction of 5% per year based on the total value of the Development Contract Fee, Architect fee, Cost to demolish the warehouse and Re-zoning fee.

Sources: https://businesstech.co.za/news/property/307172/construction-starts-on-a-new-r1-2-billion-redevelopment-project-in-joburgs-cbd/

Although the scenario is based on a real-life company, significant portions of the scenario is based on fictitious details and incorporates elements of a SAICA ITC question.

QUESTION 2 (GREEN ANSWER BOOK) (45 MARKS)

The following newspaper article on Moneyweb was written on 7 August 2019:

****Hyprop finalises Zambian mall sale to Growthpoint Investec African Properties**

Suren Naidoo / 7 August 2019 14:18

Hyprop's plan to reduce exposure to the rest of Africa (beyond South Africa) is gaining momentum with it having finalised the sale of its only asset in Zambia – the 42 000m² Manda Hill Shopping Centre in Lusaka (Manda Hill) – to Growthpoint Investec African Properties (GIAP).

This is the second African property to be sold by JSE-listed shopping centre specialist Hyprop to the unlisted GIAP joint venture in just over a month, as it looks to cut losses in the poor-performing 'rest of Africa' portfolio.

Neither Hyprop nor GIAP would reveal the value of the sale, which was announced on Monday.

Hyprop said in a statement that the disposal was in line with what was communicated to market in March this year at the group's interim results announcement, where it stated its intention to reduce exposure to sub-Saharan Africa (excluding South Africa) to "focus attention and capital on the SA and Eastern European businesses". However, Manda Hill will miss the significant support it received from the Hyprop's expertise. But management of Manda Hill feel that they will be free to make their own decisions which will be in the context of the Zambian economy.

Hyprop owned the Zambian mall jointly with AttAfrica. Fellow JSE-listed real estate investment trust (Reit) Attacq also has a stake in the AttAfrica portfolio, which has been put up for sale in its entirety. This follows Hyprop reporting an impairment of R1.07 billion on its 'rest of Africa' property portfolio, which also includes a stake in Ikeja City Mall in Nigeria.

The remaining assets put up for sale by Hyprop in the region include Accra Mall, West Hills and Kumasi City Mall in Ghana; and, the Ikeja City Mall in Lagos.

Speaking about the Zambian deal, Morné Wilken, Hyprop's CEO, said the disposal of Manda Hill Shopping Centre would reduce Hyprop's US dollar debt and impact positively on the group's loan-to-value (LTV) ratio.

Asked what its LTV now stands at following the sale of the Achimota and Manda Hill malls, Wilken said: "Hyprop's LTV, on the basis that Moody's calculates it, will drop from 43.0% to 41.7%. LTV on the basis that Hyprop calculates it will drop from 34.2% to 32.4%."

Hyprop has been looking to bring down its debt, following ratings agency Moody's downgrading the group's credit score earlier this year.

On further investigation, you found out that the Manda Shopping Centre in Lusaka was sold for R1.52 billion. Interested in how this value was determined, you were emailed the financials of the mall from a friend, Mr Frank Maluleke CA(SA), who was the Financial Manager of Hyprop. These financial statements are not yet available to the public nor were there any indications of authorised distribution granted to Mr Frank Maluleke.

Manda Hill Shopping Centre Summarised Consolidated Statement of Comprehensive			
	Notes	**12 months 30 June 2019 '000**	**12 months 30 June 2018 '000**
Rental income	**1**	311 756	312 806
Property expenses		(104 989)	(107 388)
Net property income		**206 767**	**205 419**
Other operating expenses		(5 578)	(7 823)
Operating income		**201 189**	**197 595**
Net interest	**2**	(2 823)	(3 365)
Interest Received		3 126	2 942
Interest Paid		(5 948)	(6 307)
Net operating income		**198 366**	**194 230**
Other income	**3**	4 667	3 693
Dividends	**4**	18 278	14 635
Investment property	**5**	64 636	118 179
Depreciation		(16 776)	(16 386)
Impairment of goodwill	**6**	-	(18 134)
(Impairment)/reversal of impairment of joint venture	**7**	(1 010)	-
Derecognition of financial guarantee	**8**	11 984	-
Net profit before taxation		**280 145**	**296 217**
Taxation		(3 949)	(4 340)
Profit for the year		**276 196**	**291 877**

Manda Hill Shopping Centre			
Extract of Consolidated Statement of Financial Position			
as at 30 June 2019			
	Notes	**12 months 30 June 2019**	**12 months 30 June 2018**
		'000	**'000**
Equity			
Stated capital and reserves		263 049	247 883
		263 049	**247 883**
Non-current liabilities		82 034	54 283
Interest-bearing liabilities	**9**	78 157	50 683
Deferred taxation		1 780	1 396
		161 971	**106 362**
Current liabilities		5 587	43 229
Payables		4 873	4 897
Interest-bearing liabilities	**9**	693	38 323
Derivative instruments		20	9
		11 174	**86 459**
Total liabilities		173 144	192 821
Total equity and liabilities		**436 193**	**440 704**
		-	-
Cash and Cash Equivalents		1 526	1 485

Note 1

Manda Hill rents out space in the shopping centre to patrons. Shopping revenue represents the majority of income of the shopping centre. Rental yields had reduced in the current year although occupancy had increased from 2018.

Note 2

Net interest results from interest received and paid from additional cash invested and a loan received from the local bank for the building purchase.

Note 3

Other income is received from retail sales that Manda Hill makes as a side business. The side business sells adult and children's clothes. The following information was researched and presented regarding stores in other malls:

Description	Required Rate of Return
Spar	7.0%
Woolworths Clothing and Food	9.0%
Truworths	8.5%
Spur	7.8%

Note 4

Dividends are received from shares that Manda Hill has invested in on the Zambia Stock Exchange. The average rate of return of the Zambia Stock Exchange for the top 40 shares is 15%.

Note 5

Other income is received from residential property that Manda Hill owns and rents out to residents. Residential property yields in Zambia have been averaging at 4.5% for the past 4 years. A property agent in Zambia indicated that they expect the yields to increase to 6% for the foreseeable future.

Note 6

Manda Hill's occupancy had reduced in the prior year due to the tough economic conditions. As a result, management had decided to impair the goodwill based on a lower cash generating unit calculation (IAS 36). Management is bullish in the market and believes that the economic conditions will improve in future.

Note 7

Manda Hill had entered into a joint venture with a strip mall consortium. Due to the reducing revenue from strip malls in Zambia in general, the joint venture was impaired.

Note 8

In 2016, Manda Hill gave a financial guarantee for the purchase of a personal property to one of the directors. In 2017, the director defaulted and Manda Hill recognised the financial guarantee as a liability in their financials. At the end of 2019, Management decided that since the director was now comfortable paying for the building instalments, they no longer needed the guarantee and wrote it off in their books.

Note 9

The interest-bearing liabilities represent the loan received for the purchase of the building. The loan has already been restated to reflect the current value of the loan. The short-term portion of the liability is due to be settled within 12 months.

Additional information

- A similar listed company to Manda Hill based in South Africa has an EBITDA multiple of 7.5.
- The corporate tax rate in Zambia is 35%.
- Sustainable growth rate has been reported at 6%.
- All figures in the statement of financial position are at market values.

QUESTION 3 (RED ANSWER BOOK) (MARKS 35)

RickRiders (Pty) Ltd, hereafter "RickRiders" is a private company that specialises in the manufacturing, creation and selling of innovative transportation technologies. It has a number of divisions that include the provision of services (such as product repairs and refurbishing) and the manufacture of transportation products such as motorcycles and skateboards.

The current focus has been on two divisions for the month of December, namely the Hoverboard B Division (HBD) and the Segway Scooters Division (SSD), as the holiday season is approaching which usually results in sales spikes for the two divisions.

Hover Board Division (HBD)

The HBD manufactures the UL 227 electric hover board, which is quite popular among the South African consumers and abroad. The UL 227 was launched in 2015 when hover boarding was trending on social media platforms, largely as a result of celebrities posting videos of themselves commuting on the hover boards. Since then the sales of the hover board have grown exponentially making the HBD profitable as they charge profit margins ranging from 50% to 75% on cost price of the hover boards.

The manufacturing process of the UL 227 is as follows:

The core base of the UL 227 is a 1.5kg steel frame with a central pivot point in a circular cylinder form. This allows different rotation angles for the left and right wheels at a given time to allow uncomplicated mechanical maneuvering when turning at sharp curves. This frame is bought from OreSteel (Pty) Ltd, a local supplier, at R40 per 100 grams of steel. The steel frames are delivered to HBD as a standard hover design (without modifications). OreSteel does not charge HBD for the delivery of the frames because the two entities have a long-standing relationship. OreSteel will however charge HBD a flat rate of R300 per frame ordered should the design require any changes or modifications.

Each UL 227 requires a logic board that communicates with the infrared sensors and the motors in the wheels to ensure appropriate balance of the hover board as well as accelerating and decelerating by the user of the hover board. The logic boards are imported from China at a fixed rate of ¥874.8 per logic board. Each logic board has a standard universal charging port attached to it, which directs electricity to the battery when plugged into an adapter for charging.

Infrared sensors as well as pressure pads are bought from one supplier. The supplier charges R90 per infrared sensor and R80 per pressure pad bought. Without the infrared sensors and pressure pads the hover board will not balance properly on unequal surfaces and furthermore will not allow users to accelerate or decelerate by applying and releasing pressure on the pads. Each hover board requires 2 sensors and 2 pads.

The UL 227 uses 2 electric wheels which each have a built-in motor to allow the hover board to propel forward or backward. These wheels are highly sophisticated but are commonly used with electric transportation technologies. Each wheel costs R320.

Each UL 227 uses a standard 12V 4Amp SABAT battery and these are bought at R300 each from SABAT CC. Each battery bought includes a charging adapter in the packaging.

Once all the components listed above have been assembled to the steel frame, a plastic shell and LED lights are assembled to the hover board to give it a flash look that attracts consumers when put on display. 16 000 plastic shells were in closing stock for 2018 due to an over ordering in anticipation of spiked sales. Therefore no shells will have to be bought for the 2019 year. These plastic shells were bought at R400 each in 2018. LED lights cost R10 per pack. Each UL 227 uses 4 LED packs of different colors.

Skilled laborers (electricians) assemble the hover boards from the steel frame to the LED lights. Laborers are paid R120 per hour, which is above the market related rate. RickRiders has allocated HBD R300 000 per month available to pay skilled laborers, and HBD cannot spend above this amount for skilled laborers. Laborers take roughly 30 minutes to assemble 1 hover board and hours are recorded accurately on a time sheet.

<u>Sales Demand</u>

The marketing team of HBD conducted research relating to the price elasticity of the customers who purchase the hover board and concluded the following equilibrium points:

Demand (Units)	3 800	4 100	4 400
Selling Price (Rand)	4 000	3 850	3 800

Segway Scooters Division (SSD)

The SSD manufactures a number of electric transportation technologies. The difference between HBD and SSD is that SSD manufactures products used for medium to long distances while HBD focuses on short distance and indoor commuting. Secondly the majority of SSD's products have a handle bar used to control the direction of the vehicle. One of the best-selling products in SSD is the Segway GXL electric scooter, hereafter "GXL".

The GXL is a popular Christmas present for kids ranging from ages 8 – 14. Kids use the GXL to commute between school and home during summer. Parents opt to purchase these for kids in order to allow them to travel in groups to school.

The SSD has reached maximum capacity on manufacturing and has no possible avenues of manufacturing additional units of the GXL except for purchasing specific components from HBD.

The SSD can manufacture all other required components of the GXL at R5 500 for each GXL manufactured, except for the “Deck Plate” (the straight board portion of the scooter that an individual will normally place their feet on when commuting, similar to the board component of a skateboard).

The deck plate required for the GXL requires some modification from the hover board manufactured by HBD. Therefore SSD could purchase the hover board from HBD and modify it to the deck plate requirements. Because the hover board’s wheels are on the sides of the steel frame and the GXL’s wheels are on the front and back of the steel frame, the steel frame used for the hover board is a major component that has to be modified for the purchase between SSD and HBD to take place. OreSteel (Pty) Ltd can perform this modification. The amount of steel used by the UL 227 is equivalent to that used by the GXL. The same electric wheels and LED lights will be fitted to the GXL as the hover board.

The GXL uses a bigger battery than the UL 227 as commuting is usually for longer distances. This battery price is included in the R5 500 cost of other components needed for the GXL.

Because the GXL uses handlebars for turning and balancing, the infrared sensors and pressure pads used by the UL 227 will not be needed for the GXL. However the GXL will use the same logic board used by the UL 227.

The SSD uses an aluminum body shell, which is stronger and provides more protection for the electrical components of the GXL from external force. The plastic shell used by the UL 227 is therefore not necessary for the assembly of the GXL.

The labourers will spend the same amount of time to assemble the parts for the GXL as for the hover board.

<u>Sales Demand</u>

The marketing team of SSD conducted research relating to the demand for the Segway GXL electric scooter and the following possible scenarios of additional units could be required from HBD:

Demand (Units)	600	800	1000

Additional Information

- The exchange rate for December is R1 = ¥7.29.
- Linear Programing should be ignored for all sections.