Part (a) Critically discuss the financial performance of Phantasy Marks

<table>
<thead>
<tr>
<th>Revenue</th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of room nights sold p.a.</td>
<td>17 041</td>
<td>15 215</td>
</tr>
</tbody>
</table>

**Annual change**

- Total revenue: 11.1% 10.1%
- ADR (rate per room night): (0.8%) 7.9%
- Room nights: 12.0% 6.4%
- Total room revenue: 11.1% 14.8%
- Food and beverage revenue: 12.3% 9.8%
- Conference revenue: 7.1% (8.4%)

**As a % of total revenue**

- Room revenue: 55.8% 55.8%
- Food and beverage revenue: 33.8% 33.4%
- Conference revenue: 10.4% 10.8%

**Expenses**

**Annual change**

- Salaries and wages: 9.1% 8.0%
- Marketing costs (Or % of total revenue: not both): -25.5% 65.4%
- Utility costs: 7.0% 30.1%
- Depreciation (Or % of total revenue: not both): 2.5% 2.8%
- Net interest: 15.8% 16.3%
- Total expenses excluding interest: 7.2% 11.2%

**As a % of total revenue**

- Salaries and wages: 58.6% 59.7%
- Marketing costs (Or annual change %: not both): 1.3% 1.9%
- Utility costs: 22.8% 23.6%
- Depreciation (Or annual change %: not both): 23.6% 25.6%

**Food & beverage**

- Food & beverage costs/ Food & bev rev: 36.0% 36.0%
- Or Profit: food & bev/Food & bev revenue: 64.0% 64.0%
- Or Food and beverage costs annual change: 12.3% 9.8%

**Profit margins**

- Gross profit margin: 29.3% 28.3%
- EBIT: (8 172) (8 913)
- EBITDA margin: 2.8% 0.4%
- Or Net margin (after tax): -78.6% -79.1%
- Or Net margin annual change: (16.2) -16.2%

**Return on assets using EBIT**

After reversing deferred tax

- Total assets: 231 876 238 711 1
- Invested capital: 162 093 169 662 1
- Return on total assets: (3.5%) (3.7%) 1
- ROIC (NOPAT/ EBIT/EBIT after tax): (5.0%) (5.3%) 1

**Revenue**

- Did the decline in ADR have an impact on the number of room nights sold? 1
- ↑ in room revenue in 2013 due to higher occupancy levels, as ADR’s dropped. 1
- Reduction in ADR likely i.t.o. a strategy to increase room occupancy rates 1
- Competitors aggressively cut their daily rates (influence on Phantasy?) 1
- Perhaps occupancy rates ↑ due to 3 luxury hotels being placed in liquidation? 1
- How does occupancies achieved compare to the industry average? 1
- Food & bev rev as % of total rev > 33% (industry average) / in line with industry 1
- Food and beverage revenue directly linked to room & conference revenue. 1
- Conference revenue in line with industry revenue, but below P’s target of 15%. 1
- What was the reason for decline in conference revenue in 2012? 1
Expenses
- **Salaries & wages** increases > inflation: expected given the rising cost of living.  
- Is **P** able to **reduce** salaries & wages expense given its poor profitability?  
- **P** has **high fixed costs** (salaries, wages, utility costs): over 80% of revenue.  
- **Utility costs** ↑ 30,1% in 2012: reflects large increases imposed by Eskom.  
- Utility cost ↑ 7,0% in 2013: lower than fwd 10% increase negotiated  
- Low ↑ in **deprec. = ltd inv as hotel new, but 4-yr life may show asset depletion.**  
- Declining **marketing costs** is a concern as **P** should be boosting occupancies  
- Loss bfr tax declining, but concerning given high fixed o/h & large interest bill.  

Return on assets
- ROA & ROIC negative: unable to produce a positive return on assets.  
- Low ROA: hotel profitability poor / initial over-investment: dire cond.  
- The inclusion of **interest expense**: ratios would be even worse  

**Communication skills - layout and structure; logical argument**  

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**Part (b)  Proforma statement of cash flows - 2013**

<table>
<thead>
<tr>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash flow from operations</strong></td>
</tr>
<tr>
<td>EBITDA</td>
</tr>
<tr>
<td>Interest received</td>
</tr>
<tr>
<td>Instalment interest paid <strong>(Note: May be included with liabilities below)</strong></td>
</tr>
<tr>
<td>Exclude interest on long-term loan</td>
</tr>
<tr>
<td>Taxation paid</td>
</tr>
<tr>
<td><strong>Or: Cash flow from operations</strong></td>
</tr>
<tr>
<td>Loss before taxation</td>
</tr>
<tr>
<td>Add back interest on long-term loan</td>
</tr>
<tr>
<td>Add back depreciation</td>
</tr>
<tr>
<td>Taxation paid</td>
</tr>
<tr>
<td><strong>Working capital movement</strong></td>
</tr>
<tr>
<td>Inventories</td>
</tr>
<tr>
<td>Debtors</td>
</tr>
<tr>
<td>Trade payables</td>
</tr>
<tr>
<td><strong>Financing CF</strong></td>
</tr>
<tr>
<td>Instalment sale liability <strong>(Note: May show R1 566 incl int – award above)</strong></td>
</tr>
<tr>
<td>Capital expenditure</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td>Derived net movement in cash (for calculation of total movement)</td>
</tr>
<tr>
<td>Actual movement in cash balances (for bank balance changes)</td>
</tr>
</tbody>
</table>

**Total for part (b)** 8

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**Part (c)  Calculate the occupancy level to break even – 2013**

<table>
<thead>
<tr>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed costs</strong></td>
</tr>
<tr>
<td>Salaries and wages</td>
</tr>
<tr>
<td>Other hotel expenses <strong>(Also award if included with Variable cost)</strong></td>
</tr>
<tr>
<td>Utility costs</td>
</tr>
<tr>
<td>Depreciation</td>
</tr>
<tr>
<td>Net interest</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
</tr>
<tr>
<td>Food and Beverage costs</td>
</tr>
<tr>
<td><strong>Discussion on some F &amp; B costs relating to conference revenue</strong></td>
</tr>
<tr>
<td>Contribution</td>
</tr>
<tr>
<td>Contribution %</td>
</tr>
</tbody>
</table>
Breakeven revenue required	87 913	1P
Conference and Food & Bev revenue as a % of total revenue	44,2% 	1
Or: Discuss/Deduct Conference revenue from fixed cost as fixed amount	1
Derived room revenue required (100 – 44,2% = 55,8%) 
49 093	1P
Implied number of room nights @ R 285 per night 
38 205 	1
Total available room nights (85 rooms x 358 nights) 
30 430	1
Or: R38 205 / 85 rooms = 449 nights required
Breakeven occupancy 
125,55% 	1
Impossible to break even as BEP greater than capacity	1

Total for part (c)
12

Part (d) Critically discuss current & future solvency & liquidity Marks

<table>
<thead>
<tr>
<th>Debt management</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity: Reverse deferred tax</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Include preference share capital</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Net interest bearing debt/Equity</td>
<td>(393%)</td>
<td>(261%)</td>
</tr>
<tr>
<td>Interest cover</td>
<td>(0,3)</td>
<td>(0,2)</td>
</tr>
<tr>
<td>Working capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory days (F&amp;B plus consumables)</td>
<td>289</td>
<td>277</td>
</tr>
<tr>
<td>Debtors days</td>
<td>36</td>
<td>38</td>
</tr>
</tbody>
</table>

Comments on debt management
• Loss before interest, hence negative interest cover: unable to cover fin charges. 1
• Net interest-bearing debt significantly > than equity on B/S: concerning 1
• Need to address d-e ratio: ↑ equity capital (cash injection) / d-e conversion 2

Comments on working capital
• Inv days ↓ - mostly bev (food perishable): seems high – reduce to release cash 2
• Debtors days consistent; balances high as pmts cash/mostly use travel agents? 1

Meaning of solvency and liquidity
• Solvency implies that assets fairly valued exceed the value of liabilities. 1
• Liquid: able to pay debts, ordinary course of business, as due over next 12 mnths 1

Solvency
• Phantasy insolvent at face value on 30/9/2013 as liabilities > assets by R64,8m. 1
• Preference shares deemed equity as not redeemable except at dir’s discretion 1
• Deferred tax asset: reverse until probable that will generate sufficient tax income 1
• FV of land & buildings ↑, but hotels = specialised assets: only worth profits,CF 2

Liquidity
• Debts to be paid over next 12 months = trade creditors & instalment sale. 1
• No repayments of interest or capital on LT loan required (holiday until 4/2016) 1
• Pref div’s does not need to be paid which will help liquidity in the short-term. 1
• Liquid as generated sufficient positive cash flow in FY2013 to service debts 1
• P has R63,7m in cash to cover creditors and instalment debt. 1
• P’s future liquidity doubtful: unlikely to make profit unless occ & ADR ↑ a lot 1
• Its breakeven occupancy level at the current ADR is 125,5% of capacity! 1
• Interest charges will ↑ as capitalised interest increases overall debt balance 1
• Will not be able to afford annual loan repayments of R63,4m p.a. in FY2016 1

Communication skills – logical argument
1
Total for part (d)
13

Part (e) Id & motivate 4 viable ways to improve solvency and liquidity Marks

Additional equity
1
• Converting preference shares to ordinary shares will do nothing - fresh equity is needed. Does Mr Phillips have the ability to raise any? 1
• Could an investor or strategic partner be found who’s willing to invest? 1
• To raise equity, P must be listed: don’t meet Listing Requirements (profit history). 1
### Convert long-term loan into equity

- **Consortium owed R323.7m, with limited prospects of being fully repaid**
- "P" could approach Consortium to **convert** part of loan to ordinary shares (↑ ratios)
- **Equity dilution** for Phillips severe due to losses incurred & bleak prospects

### Renegotiate the interest rate on the loan (alt: restructure the loan)
- 13% p.a. > prime overdraft rate and property loans generally lower than prime
- **Offer** Consortium interest rate of ‘prime–1%’ in return for bond over L&B
- **Annual interest saving** could be significant: rate of 8% p.a. = ±R13m int savings
- Consortium willing to **restructure loan**: allow repayments over longer period?

### Increase room tariff rates
- Hotel sensitive to room tariff rates. 3 others liquidated: may be scope to ↑ rates

### Boost occupancy levels
- **Discounted ADR** will ↑ losses. ↑ occupancy with **bulk rooms** @ same ADR
- **Market conference packages** with discounted ADR’s to ↑ occupancy, F&B rev
- **Large fixed costs** p.a.: any ↑ in revenue will flow directly to profits & CF

### Enter into a compromise with Consortium
- Negotiate a **write-off of historic interest charges** in return for equity stake
- Cons unlikely to **repaid cap+int**: with compromise P can use tax loss & Cons can claim tax deduction (currently paying tax on int not received).

### Sell hotel and enter into management agreement
- Sell property to 3rd party at **market value**, use proceeds to partially repay Cons.
- Enter into a **sale and leaseback** arrangement in respect of the property.
- **Write off balance** of loan, mngmt agreement with new property owner, and offer the Consortium an equity stake in Phantasy.

| Communication skills – logical argument | 1 |
| Total for part (e)                     | 13 |

### Part (f) Identify unethical behavior

- Mr Phillips paid **undisclosed commission** to investment advisers
- Raising preference share capital on terms **unduly biased** towards Phantasy – no firm rights to div/cumulative rights/ redemption rights: affect P’s credibility.
- Acquired property from Trust: related party tx: sold at fair market value?
- **Environment**: King III: Construction delays: Opportunity cost of late opening
- **Friend as general manager**: due procedures in advertising? Mr Dwight beholden
- Inappropriate hospitality from supplier (free holiday in Moz): not objective
- Mr Dwight’s son handles staff recruitment – conflict of interest and nepotism!
- Loan agreement @ interest rate > market rates & no repayments until 2016? Irresponsible towards the employees and creditors.
- Mr Phillips reached agreement with the Consortium without the involvement of the board of directors/oversight committee
- P ‘buying’ **BEE certificates**: not embracing Code & complying with regulations.
- Loyalty programme: conceal benefits from travel agents/employers: not transparent / tax.
- Musician to be paid with complimentary services: assisting him in evading tax.
- Meetings with local hotel owners: price fixing, disadvantage the hotel patrons
- False invoices to business travellers: aid & abet defrauding their employers through **bogus expense claims**
- Directors of Phantasy appear to be puppets of Phillips: corporate governance?
- **Trading recklessly**, in breach of Co Act: dir’s personally liable for losses
- Mr Phillips intentions to bypass governance structures: reckless actions & lack of due care (section 76 and 77 of Companies Act)
- Adult movies as room service charges: abetting clients in defrauding employers.

| Communication marks – clarity of expression; logical argument | 2 |
| Total for part (f)                                           | 24 |