QUESTION 1 **50 marks**

1 Introduction

C2C (Pty) Ltd ('C2C') is a passenger bus company operating between all major cities across South Africa. It offers luxury long-haul intercity travel. The company credits its past success to its fleet of buses being equipped with safety equipment, air conditioning and heating, as well as audio entertainment. Recently, C2C has been experiencing financial difficulties caused by a range of new alternative competitors entering the market, which include intercity trains, low-cost airlines and long-distance minibus taxis. The year end of the company is 31 December.

C2C's board of directors has tried to keep the company afloat through the implementation of various strategies, but the company is still facing significant financial difficulties. These include declining revenue, volatile profit margins and a large debt burden. The Covid-19 pandemic, with the resultant travel restrictions that were imposed, severely worsened the situation.

The board of C2C recently convened to discuss progress made on the turnaround strategy of the company. Extracts of the minutes of that meeting are presented below:

2 Extracts of the minutes of the board meeting: 10 November 2021

Matters discussed

1 As initially discussed during the prior board of directors' meeting (held on 20 September 2021) the following strategies were to be implemented to help the business recover:
   1.1 Restructuring: certain non-profitable bus routes were to be closed down.
   1.2 Retrenchments were to be implemented in respect of a portion of the labour force, specifically bus drivers on closed routes.
   1.3 Funding of R40 million was to be obtained from a bank to assist with short-term liquidity and with investments in new buses. New buses should provide C2C with a competitive edge.

2 Performance evaluation.

Report back

The chief financial officer (CFO), Palesa Vuma, reported back on these matters as follows:

1.1 Restructuring

Non-profitable bus routes were closed down in all nine provinces. A number of the buses on these routes were transferred to more profitable routes, while the rest are not being used at present. During December 2021, one bus was sold to Bus Repairs (Pty) Ltd ('Bus Repairs'), a company that services and repairs buses. As the company is owned by my father-in-law, I was able to negotiate a good sales price on the bus. A maintenance agreement in terms of which Bus Repairs will service all C2C buses for the next five years was included in the sales contract. As you know, our previous maintenance provider was liquidated recently, and therefore C2C would have had to open a tender process for a new maintenance provider if I had not found this brilliant solution. A tender process is now not needed at all, and thus I believe that this agreement has saved us a lot of time (and money). It's a win-win situation!

1.2 Retrenchments

As a result of the restructuring, several bus drivers had to be retrenched. The bus drivers felt that they were unfairly dismissed and are now taking us to the Commission for Conciliation, Mediation and Arbitration (CCMA). They are requesting higher retrenchment packages and arguing a case for unfair dismissal. We have hired some of the best labour lawyers in the industry and I anticipate this situation to be resolved shortly.

Furthermore, earlier in the year the bus drivers went on strike because they were unhappy with the wages they earned, which were 20% lower than the industry average. Several buses sustained damage during the strike. Fortunately, our insurance covered the bulk of the repair costs.

Luckily, the trade union was able to negotiate with the bus drivers, the strike was halted, and the bus drivers returned to work. I had instructed the chief operating officer to offer the head of the trade union a bursary for his daughter to study in the United Kingdom next year. They know each other very well and play golf together on a regular basis. The bursary is C2C's way of thanking the trade union leader for all the good work he has been doing over the years.

1.3 ***Funding***

1.3.1 Innovation Bank

C2C applied for an additional loan with our banking provider (Innovation Bank) during October 2021 to fund a R40 million capital investment. This was required to implement the business recovery strategies and to ease short-term liquidity pressures. The loan was denied. Innovation Bank stated that C2C is already in danger of defaulting on the re-negotiated debt-equity ratio covenant of 1,6:1 on its current loan. The covenant was re-negotiated (increased from 1,4:1) in 2020 to provide temporary relief to C2C after the initial lockdown regulations were put in place. Should the covenant be breached again, the full loan will become payable immediately.

Innovation Bank advised C2C to rather raise equity to fund its investment, which will result in an improvement in the debt-equity ratio.

1.3.2 Rights issue

I have decided that the best course of action is to follow the recommendation of Innovation Bank and to issue sufficient shares to fund the capital investment.

To ensure adherence to appropriate internal due process, I will prepare an EBITDA multiple-based valuation of C2C. This will also serve as motivation to us, as the directors who own a large shareholding in CTC, to exercise our rights in the planned capital raise.

We will probably have to price the rights issue at an appropriate discount to entice all the existing shareholders to exercise their rights. I must note that, if all shareholders do not take up their full rights, it could affect the control of the company. I therefore want to suggest that any members of this board who are not able to take up their rights sell their rights to me; this will ensure that control remains in our hands.

2 Performance evaluation

Although my update provides an overview of the success of the various strategies, I do think that this should be assessed in a proper ratio analysis. I think this should include a consideration of the following ratios:

2.1	Net profit margin (%)	2.4	Assets to equity (%)
2.2	Interest cover (x)	2.5	Debt to equity (%)
2.3	Asset turnover (%)		

I believe these will give us a good indication of the quantitative level of success achieved on these strategies and interventions to date.

3 Valuation of C2C

Palesa asked the newly appointed financial manager to assist her with the preparation of the valuation referred to in the board minutes. The following information was provided:

Extract from the annual financial statements

Statement of financial position				
	Notes	**2019**	**2020**	**2021**
		R'000	**R'000**	**R'000**
Total assets		156 489	138 552	135 860
Equity	1	(57 812)	(56 318)	(57 906)
Total liabilities		(98 677)	(82 234)	(77 954)

Statement of comprehensive income				
	Notes	**2019**	**2020**	**2021**
		R'000	**R'000**	**R'000**
Revenue		85 669	67 283	78 520
Operating expenses	2	(76 984)	(54 915)	(72 560)
Other income	3	14 695	16 321	22 530
Impairment	4	–	(15 558)	(13 130)
Depreciation		(13 275)	(11 250)	(9 470)
Finance costs		(3 578)	(3 375)	(3 190)
Legal costs	5	–	–	(400)
Profit / (loss) before tax	6	6 527	(1 494)	2 300
Taxation expense		(2 274)	–	(712)
Total profit / (loss)		4 253	(1 494)	1 588

Notes

1 Authorised share capital consists of 100 000 shares, of which 90 000 shares were in issue throughout all three years for which the information was provided.

2 Included in operating expenses for FY2021 are bus driver salaries of R30 million. These salaries only apply to those bus drivers who were not part of the retrenchment process (refer to the extract of the board meetings).

Also included in the FY2021 operating expenses is an amount of R5 million for additional repairs to the buses damaged in the strike.

3 An insurance pay-out of R4 million for the damaged buses is included in other income for FY2021. The amount was less than the cost to repair the buses, due to the insurance excess C2C had to pay in terms of the insurance contract.

Other income for FY2021 also includes a profit of R1 million generated on the sale of a bus. The bus had an original cost of R3 million when it was purchased on

2 January 2019. It was sold for R3,1 million. C2C had applied for a directive from the South African Revenue Service on the capital allowance for its buses and was granted a four-year straight-line write-off period. The useful life of a bus is considered to be ten years.

4 The impairment losses relate to write-downs on ageing fleet and goodwill from prior acquisitions.

5 Legal costs relate to payments to the legal team representing C2C in the CCMA dispute.

6 The losses that were incurred on the routes that were discontinued amounted to R2 million during FY2021.

EBITDA multiples of listed transportation companies

Palesa obtained the following comparative EBITDA multiples for the transportation industry:

Name	Description	Multiple
Purple Panther Buses Plc	• Purple Panther Buses Plc is a British passenger bus company. • It has a fleet size similar to that of C2C. • It primarily operates in England.	4
Inter Ltd	• Inter Ltd is a passenger transport company operating a modern fleet of buses in all major cities in South Africa. • The company also owns a fleet of minibus taxis that operates in the areas to which buses do not have access. • The company has no debt.	5
Banana Airways Ltd	• Banana Airways Ltd is a low-cost airline that flies on the same routes that C2C buses travel. • It has similar levels of financial gearing.	7
RailwaysSA Ltd	• RailwaysSA Ltd offers its passengers luxury train journeys from Johannesburg to Cape Town. • The company has net cash on its balance sheet.	6

Using the above information provided by Palesa, the financial manager prepared the following preliminary valuation, which is arithmetically correct:

Description	**R'000**
Profit after tax	1 588
Adjustments (after tax)	
Repairs after strike (5 000 x (1–28%))	3 600
Sale of bus (3 100 x (1–28%))	(2 232)
Legal fees (400 x (1–28%))	288
Total adjusted profit after tax	**3 244**
Multiple	
Purple Panther Buses Plc	4
Adjusted for high debt-equity ratio of C2C	1
Adjusted multiple	**5**
Total equity value (3 244 x 5)	**16 220**

INITIAL TEST OF COMPETENCE, JANUARY 2022

PROFESSIONAL PAPER 4

<table>
<tr><th colspan="2" rowspan="2">PAPER 4 QUESTION 1 – REQUIRED</th><th colspan="2">Marks</th></tr>
<tr><th>Sub-total</th><th>Total</th></tr>
<tr><td>(a)</td><td>Discuss six key business risks that C2C is currently facing.

Communication skills – appropriate style</td><td>9

1</td><td>

10</td></tr>
<tr><td>(b)</td><td>Assist Palesa in setting up the ratio analysis by –
(i) calculating, for all three years, the applicable ratios for the performance evaluation noted in section 2;
• Use year-end balances in your ratio calculations;
• Round to one decimal on all final answers; and
(ii) discussing the outcome of your calculations.</td><td>6

5</td><td>

11</td></tr>
<tr><td>(c)</td><td>With reference to the preliminary valuation performed by the financial manager –
(i) criticise the valuation (do not re-perform the valuation); and
(ii) discuss the appropriateness of using an earnings-based valuation method to value C2C in its current circumstances. Provide alternative valuation methodologies that you may consider to be more appropriate to support your discussion.

Communication skills – clarity of expression</td><td>12

6

1</td><td>

19</td></tr>
<tr><td>(d)</td><td>Discuss, with reference to section 2, the corporate governance concerns you may have regarding the conduct of C2C's directors with reference to the King IV Report and the Companies Act.

Communication skills – clarity of expression</td><td>9

1</td><td>

10</td></tr>
<tr><td colspan="2">Total for question 1</td><td></td><td>50</td></tr>
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