Part (a) Discuss six key business risks that C2C is currently facing.	**Marks**
The Going Concern risk:	0.5
• There is a risk that the company might not be able to continue as a **going concern because a** large number of **competitors** has entered the market recently (including low cost airlines) and it appears as if the company does not have a competitive advantage.	1
• Due **to the current economic environment** which has further contributed to the struggles of the company and this does not appear to show any improvement in the near future.	1
• Given that C2C offers a luxury bus service, the **prices of the tickets to travel are probably quite high** (they attract a premium for the quality service) – with slow economic growth and Covid-19, consumers are struggling to put food on the table. If they have to travel, they will probably opt for a less expensive option. – this would put **C2C's sustainability and recovery at risk**.	1
• If the **shares are not taken up from the rights issue, or not taken up fully**, which is very possible given that C2C is a private company that may not approach the general public to take up shares, and it only currently has 10 000 shares to issue	1
• The **company has an ageing asset base,** with old/outdated buses that will soon require replacement, but the company does not have resources to refresh the asset base. This may decrease any competitive advantage C2C may previously have had.	1
The Operational risk:	0.5
• **Due to continued lockdowns** (driven by the Covid-19 pandemic) which may prevent C2C from trading out of its current predicament, with lower passenger numbers for longer than forecast.	1
• **Due to personnel who may become ill affecting C2C's ability to operate effectively**. If the SA government institutes vaccination passports, the number of passengers may dwindle further.	1
• C2C's exposure to rising fuel prices is a relevant further key business risk. This road transport industry would be negatively impacted at a margin level by soaring oil prices globally	1
• **Due to violent protests** on bus routes which may **result in damage to the business and/or physical harm to passengers and drivers.**	1
• **As the workforce is not happy with current wages** (below market rates) therefore there is a risk of future unrest if salaries are not increased, leading to more destruction of property (or **loss of key employees**).	1
• The **impact of the loss of the repairs/maintenance service provider** needs to be assessed as this could increase operational risk going forward (especially if a new, unreliable service provider is selected from not following the proper tender processes).	1
• Due to the restructures and retrenchments that have occurred, there is a risk that **employee morale will be low** affecting productivity going forward.	1
There is **solvency / gearing / liquidity risk:**	0.5
• since **C2C has high levels of debt and is close to breaching debt covenants**, consequently there is a risk that the company will not be able to generate sufficient capital to survive this difficult period / that loans will become payable immediately.	1
There is **refinancing risk:**	0.5
• **since C2C's bank declined a short-term loan application**. This raises questions about C2C's sustainability.	1
The **financial / regulatory / litigation risk:**	0.5

• Due to**multiple instances of non-compliance with the Companies Act** (potential reckless trading, fraud, breach of fiduciary duties, etc.) which increases possible fines and penalties that could be imposed.	1
The reputation/fraud/litigation risk • **Management integrity is questionable**, especially concerning the bribe paid to the trade union. • **due to C2C's involvement in a case of unfair dismissal**: could lead to further outflows for legal expenses, possible future costs of settlement and risk of reputation being tarnished if found to be guilty.	0.5 1 1
The Safety risk: • as a result of aging assets and this puts the lives of passengers at risk	0.5 1
Available	**21.5**
Maximum	**9**
Communication skills – appropriate style	*1*
Total for part (a)	**10**

Part (b) 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; and • Use year-end balances in your ratio calculations. • Round to one decimal on all final answers.				**Marks**
Description	**2019**	**2020**	**2021**	
Revenue	85 669	67 283	78 520	
Total Profit/(Loss)	4 253	(1 494)	1 588	
Total Assets	156 489	138 552	135 860	
Equity	57 812	56 318	57 906	
Total Liabilities	98 677	82 234	77 954	
Ratios				
Net profit margin (%)	5,0%	(2,2%)	2,0%	1
Interest cover ratio (x)	2,8	0,6	1,7	2
Asset turnover (%)	54,7%	48,6%	57,8%	1
Asset:Equity (%)	270,7%	246,0%	234,6%	1
Debt:Equity (%)	170,1%	146%	134,6%	1
			Available	**6**
			Maximum	**6**
			Total for part (b)(i)	**6**

Part (b) Assist Palesa in setting up the ratio analysis by – (ii) discussing the outcome of your calculations.	**Marks**
The impact on the company of the COVID-19 pandemic can clearly be seen in some of the key ratios as there are significant decreases in the interest cover, asset turnover and net profit margin ratios from FY2019 to FY2020.	1
The net profit/loss margin improves from the FY2021 year due to the easing of the lockdown restrictions, probably as a result of normal trading commencing to some degree (with the removal of restrictions). However, the improvements are not strong enough to bring the business to pre-Covid ratios. Considering the large impairment in FY2020 and FY2021, this ratio could potentially show even greater improvement in future.	1 1
The removal of the non-profitable routes therefore appear to have made a significant improvement in the profitablity of the company. For a proper analysis of the trend in the profitable routes' income and returns, the income and cash flows from the two groups (profitable and non-profitable) ought to be split.	1 1
This has led to an improvement in the interest cover ratio in FY2021 from the company's inability to cover interest in FY2020 A comparison to C2C's competitors' information may cast more light on the acceptability of this ratio *(this applies for all ratios).*	1
The asset turnover ratio improved in FY2021, and the revenue of the company increased by approximately R5 million, therefore the decision to close loss-making routes, reallocating and selling some assets has been a good strategy. This is almost certainly as a result of a more depreciated asset base given only one bus was sold. There was a significant decline in the FY2020 total asset base which exceeds the depreciation in that year. This is probably as a result of the large impairments record in that year, which would have helped boost the FY2021 asset turnover ratio.	1 1

The company should consider selling/re-allocating more of the buses that were removed from the loss-making routes to improve the asset turnover ratio further.	1
There has been a steady decline in the total asset : equity ratio, potentially illustrating the ageing fleet of buses. The company should consider reinvestment in assets.	1
Although the debt:equity ratio has improved since last year, there is still significant risk that the covenant will not be met in the coming year, especially if the rights issue is not successful (and/or there are further lockdowns). Therefore the loan might become due and payable (although a breach in 2019 seems to have been waived by the lenders).	1 1
Available	**13**
Maximum	**5**
Total for part (b)(ii)	**5**
Total for part (b)	**11**

Part (c) With reference to the preliminary valuation performed by the financial manager – (i) criticise the valuation (do not re-perform the valuation); and	**Marks**
One of the drawbacks of the valuation performed is the fact that it focuses on historic figures, rather than future benefits to be received.	1
Using profit after tax as the earnings base is incorrect as this is an EBITDA multiple valuation and hence EBITDA needs to be determined.	1
This EBITDA should then have been adjusted for the following items which are currently not adjusted to derive maintainable EBITDA:	1
• Adding back any excess paid to the maintenance contract provider if it was not at arms length or market related rates. The impact of the maintenance service rates of the new agreement with the CFO's father in law and its impact on the valuation needs to be considered.	1
• Insurance payout has not been adjusted for as a once-off event - therefore overstating maintainable EBITDA (should be subtracted).	1
• The strike damage costs should also be removed as a once off item.	1
• Losses from discontinued operations were not adjusted for. It is not a maintainable amount and therefore should be removed.	1
• It is debatable whether the EBITDA should be adjusted downwards by ~R7.5 million (R30m / 80% - R30m) to reflect salaries of drivers which are currently 20% below market.	1
• Just the profit from selling the bus should be removed as it would be reflected in the statement of comprehensive income and not the proceeds from the sale.	1
No tax adjustments should be made to the above adjustments as this is an EBITDA multiple based valuation (EBITDA is pre-tax).	1
• Impairment/non-recurring should be removed. • Although impairment is not normally taken into account in an EBITDA based valuation, it needs to be considered if this is really not an indicator that maintainable earnings are not appropriate and are potentially overstated. • Consider what changes are likely to happen in the future (e.g. sales growth, if not already reflected in the multiple) as a result of the reallocation of the buses. Also reflect on when the reorganisation took place – has a full year's additional income from the change been included? If not, extrapolate accordingly.	1 1 1
It is best to determine a trend to predict future earnings – thus, the manager should have looked at the information from ALL three years (after the adjustments were made to remove abnormal or once-off items) before deciding to use information from FY2021 information only.	1
In fact, given the current upheavals from Covid-19, the last two years' information may not be useful at all (outliers) or, at best, a weighted average earnings figure should be used to determine maintainable earnings.	1
The incorrect multiple was selected – EBITDA-multiple of Inter Ltd should have been used as it is the closest competitor with a business model that best resembles C2C's. Purple Panther is a British company; therefore it would not be appropriate to use the EBITDA-multiple to value a local company (and if used, would need to be adjusted for differences in country risk). Banana Airways and Railway SA are airways and a railway company, therefore it would not be appropriate to use EBITDA multiple to value C2C	1 1 1
The debt : equity ratio adjustment to the multiple is in the wrong direction (i.e. should be to decrease, not increase the multiple) – regardless, given this is an	1

EBITDA based valuation no adjustments for leverage are necessary to the multiple given debt is subtracted from the enterprise value.	1
However, as C2C is not a listed company, a number of adjustments to the EBITDA multiple (e.g. based on the size of the company or its market share) – adjusting the multiple down – would have been appropriate.	1
To arrive at equity value, this should then be adjusted by adding back non-operating cash And deducting the market value of thedebt. The busses that are not being used on the routes, and are therefore not included in the revenues, represent additional assets, and should be valued, and added as assets not currently used and can be disposed of (or utilized in a new route etc.)	1 1 1
The remaining other income should be investigated as to whether it represents a separate asset that should be valued as a different risk asset, and added to the valuation as a dissimilar asset.	1
Available	**25**
Maximum	**12**
Total for part (c)(i)	**12**

Part (c) With reference to the preliminary valuation performed: **(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.**	**Marks**
The earnings-based valuation methods are based on maintainable earnings:	
Currently the company is experiencing difficulties / unusual circumstances due to the Covid-19 pandemic, therefore FY2021 might not be representative of maintainable earnings.	1
Current earnings might not be maintainable due to industry and entity-specific issues C2C is facing (e.g. given the number of competitors in the market, there is no indication that the company can retain its customer base in the future). The current earnings also are compromised by the number of abnormal items included, especially in FY2021, that require adjustment. The business also made losses in the past year – it is only now returning to profitability: thus the profit figure may be understated (if conditions are expected to improve) or overstated (as noted above). The past results of the company may not be indicative of its future expectations.	1 1
Furthermore, given the impairments being recognised in the current and prior years, consideration needs to be given to whether any adjustments need to be made to maintainable earnings (or the valuation) to take into account the information content of the large impairments.	1
A significant propotion of the final maintainable earnings figure is made up of other income, therefore using a earnings-based multiple for C2C may not be appropriate as a large proportion of the maintainable earnings is not generated by operations.	1
The earnings can be easily manipulated by the management of the company, especially as they also have a majority shareholding.	1
Valuing C2C in the midst of a pandemic is further impacted by the fact that share prices (and therefore multiples) of listed comparables may be depressed. (Or too high, if earnings were low but prices remained unaltered.)	1
Considering that the company is in financial distress (no access to bank funding etc.), a net asset value / liquidation basis valuation might be more appropriate. However, the NAV method does not recognise the income-generating abilities of the assets included in the valuation, and therefore tends to undervalue a business.	1 1

C2C has not indicated at this stage that it may consider liquidiation, and therefore it is probably not the right method to use just yet.	1
Alternatively, the discounted cash flow (DCF) method should be used, incorporating future recovery plans and more information on the cash flows (especially in a more normalised environment) can be incorporated to provide a more accurate valuation.	1
Caution should be applied though, as the cash flows are predictions, and it would be easy to be over-optimistic about C2C's chances for survival and recovery.	1
At a minimum, a sensitivity / scenario analysis should be performed given the high degree of uncertainty that relates to the future of C2C's operations	1
Available	**13**
Maximum	**6**
Total for part (c)(ii)	**6**
Communication skills – clarity of expression	*1*
Total for part (c)	**19**

Part (d) **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.**	**Marks**
The governing body <u>should be ethical and provide effective leadership</u> according to principle 1 of King IV. • This principle is not being adhered to, as C2C directors are not being transparent in its dealings and are not acting with integrity (they are effectively paying a bribe to the trade union leader). • This is also evidenced by the CFO circumventing the tender process and other directors being sileng on the matter. The governing body should assume <u>responsibility for ethics within the organisation, creating an ethical culture</u> as per principle 2 of King IV. • The directors do not appear to be instilling ethics in the organisation and the 'tone at the top' appears questionable, for example, C2C remains silent on the matter of the bribe. First, a bribe is not ethical, and • Second, they are not handling or reporting the bribe, which does not create an ethical culture.	1 1 1 1
The governing body should ensure that the organisation is and is seen to be a **responsible corporate citizen** as per principle 3. • This principle does not appear to be followed in view of the organisation paying their bus drivers less than market rates. • Furthermore, rather than dealing with the unhappiness of the work force, C2C resorted to a bribe to silence the matter. • This also leads to the company being in breach of principle 14, requiring fair remuneration within the organisation. • There is also allegations of unfair dismissal and C2C is currently involved in CCMA proceedings. • The CFO did not disclose her personal financial interest or avoided making decisions in the bus sales transaction and is not being a responsible corporate citizen and acting with integrity. • Would also be in breach because directors are not following proper tender processes which will not be regarded as fair and honest.	1 1 1 1 1 1
• The board's failure to "comply" with the last recommended practice under principle 4 of the King IV Code ("As part of its oversight of performance, the governing body should be alert to the general viability of the organisation with regard to its reliance and effects on the capitals, its solvency and liquidity, and its status as a going concern")	1
Principles 7 & 8 of the King IV envisage a **balance of power** in the effective and ethical steering of the company: • However it appears as if the CFO is making all the key decisions on behalf of the board of directors. • The CFO can be seen as the dominant force on the board (as none of the other directors are challenging her decisions (based on extracts from minutes) even though they are not in compliance with the Companies Act and the decisions are unethical. • The CFO also ordered the rest of the board to sell their rights to her without considering their intentions with the rights issue.	1 1 1
Principle 13 requires the board to govern in <u>compliance with laws and regulations.</u> This principle is in breach due to the following (C2C is in breach of the following Companies Act sections (thus breach of principle 13):	1

• S22: The company is not liquid, has a large amount of debt and is planning on borrowing additional funds. This could be considered reckless trading as the company may not be able to settle its debts as they become due and payable. • Linking S22 to Principle 4.8 relating to the boards oversight of its performance that specifically relates to being "alert" to the viability and liquidity and solvency of the organisation.	1 1
• S38: The CFO unilaterally decided to issue more shares. Therefore appropriate approvals were not received for the issue of shares (i.e. board resolution)	1
• S39: the entity is private company the issuing of shares should be done in proportio of the existing shareholding, i.e. the rights must be equally awarded	1
• S40: which speaks to adequate consideration – This is not the case here especially with the company facing liquidity problems. As the CFO seem to have more power and also has interest in buying more, they could possibly be sold at a big discount as this would mean savings for him.	1
• S36: It does not appear as if a special shareholders resolution has been obtained to change the MOI to allow for the rights issue.	1
• The CFO has personal financial interest (father-in-law owns the business) in the sale of the bus transaction and awarding of the maintenance contract, therefore she should not have been part of the decision making.	1
• <u>S76</u>: Based on the CFO's behaviour, it is clear that the directors are not acting in the best interest of the company. They are thus in breach of their fiduciary duties • <u>E</u>.g the CFO is using her position to benefit a family member and would therefore be gaining an advantage over the company.	1 1
• <u>S77</u>: Directors can therefore be held personally liable for any losses suffered by the company based on the above.	1
• S112: Consideration should be given whether the restructuring would constitute the greater part of the business which would require a special resolution	1
• The non-compliance with the Companies Act could be an indication that the company possibly does not have a company secretary or that the person is not performing his/her duties properly. In accordance with King IV <u>Principle 10 paragraph 90</u> the governing body must ensure that they have access to a professional corporate governance specialist/company secretary who can offer guidance to the governing body regarding legal obligations.	1
• As the CFO makes decisions on behalf of all directors, this may also call into question the ability of the non-executive directors to be independent. If non-executive directors are not independent, this would then cause the board and sub-committee composition to not be appropriate.	1
Available	**28**
Maximum	**9**
Communication skills – clarity of expression	*1*
Total for part (d)	**10**
Total for question 1	**50**