Part (a)	**Calculate the IRR for option 1: Dark kitchen and accompanying software application** • **For calculation purposes, assume that today's date is 31 December 2022.** • **Limit your analysis to the period up to 31 December 2025.** • **Provide brief reasons for omissions/exclusions from your calculations.** • **Round all workings and answers to the nearest whole number.**				**Marks**
	2022	**2023**	**2024**	**2025**	
	R'000	**R'000**	**R'000**	**R'000**	
Market research - sunk / irrelevant cost					1
Franchise income (W1)		0	4 392	4 932	
App development 2023: USD750 000 x 16,8 2024: [USD750 000 X 1.04 x 17.85	(12 600)		(13 923)		3P
Rental saved		13 000	13 780		2
Penalty fee paid		(3 000)			1
Dark kitchen rental			(1 000)	(1 060)	1
Tax (W2)			(123)	(1 273)	1P
Cash flows	**(12 600)**	**10 000**	**3 126**	**2 599**	
IRR	16%				1P
Workings	**2022**	**2023**	**2024**	**2025**	
W1: Franchise fee					
Revenue from existing customers - non incremental					1
Revenue from existing customers foregone (3 600 x 18%)			(648)	(648)	2P
Additional revenue - new customers			5 040	5 580	1
Franchise income			**4 392**	**4 932**	
W2: Tax calculation	**2022**	**2023**	**2024**	**2025**	
App allowances [(1,500x17,25)/2]			(12 938)	(12 938)	2
Rental			13 000	13 780	1
Franchise fee (W1)			4 392	4 932	1P
Penalty fee			(3 000)		1
Dark kitchen rental expense			(1 000)	(1 060)	1
Taxable income			454	4 714	
Tax at 27%			**123**	**1 273**	
				Available	**20**
				Maximum	**19**
				Communication skills – presentation and layout	***1***
				Total for part (a)	**20**

Part (b)	Calculate the IIR for option 2: EatWell • For calculation purposes, assume that today's date is 31 December 2022. • Assume that Sun Food sells its stake on 31 December 2025. • Round all workings and answers to the nearest whole number.	Marks

EBITDA in 2025	**R'000**	
Net cash inflows from operations (given)	23 081	0.5
Adjusted for:		
Unearned profit from Sun Food (2 686 – (2 686/1,1))	244	2P
*Alternative calculation: (2 686 * 0.2 / 1.2) - (2 686 * 0.1 / 1.1) = 204* *Alternative calculation: (2686*90% = 2417*100/80 = 3021-2686 = 355*		
Net finance costs (given)	922	1
Taxation (given)	4 928	1
EBITDA – Adjusted	29 175	1P
Multiple (given)	6	
Entity value (6* 29 175)	175 051	1P
Add: Surplus cash (74 400 – 25 000) *Alt: Questions that operational cash is historic*	49 400	2P
Less: Market value of debt	(9 800)	1
Equity value	**214 651**	1P

IRR Calculation	**2022**	**2023**	**2024**	**2025**	
	Y0	**Y1**	**Y2**	**Y3**	
First payment	(16 000)				1
Second payment		(8 000)			1
Dividend received (2023: 19610*0,4*0,3; 2024: 20983*0,4*0,3; 2025: 23081*0,4*0,3)		2 353	2 518	2 770	1.5 1C
Proceeds on disposal (214 651*0,3)				64 395	1P
CGT payable [((64395 – 24000)*0,27*0,8))]				(8 725)	2P
Cash flows	**(16 000)**	**(5 647)**	**2 518**	**58 440**	
IRR	46%				1P
				Available	**19**
				Maximum	**19**
				Total for part (b)	**19**

Part (c)	Provide a recommendation on the best investment option for Sun Food, taking into consideration your calculations in part (a) and (b), as well as any relevant strategic factors. • Do not perform any further calculations.	Marks
1	**The dark kitchen and accompanying software application (option 1)**	
1.1	The dark kitchen project will involve the creation of a software app, which may not be preferred over existing food delivery apps, especially since the latter are well-established in the market.	1
1.2	Sun Food is unlikely to have the expertise of a software specialist required to monitor and manage the operations of the app and the establishment of a helpdesk for customer support (e.g. incorrect deliveries) and has not included this additional aspect of work in their financial projections or operational plans.	1
1.3	It is also not clear who will ultimately be responsible if there are any issues during the delivery of meals from the virtual kitchen to the customer – will it be Sun Food or CC? Should there be issues, customers could hold Sun Food responsible, potentially resulting in a loss of reputation and payment of legal costs.	1
1.4	Sun Food does not seem to have considered the vetting of drivers before they are loaded onto the app or any regulatory issues related to the services they provide to the company, given the level of trust placed on them to deliver the meals on time and in good condition. Sun Food has not considered the number of drivers required to service the customers who order via the app. Failure to get drivers onboard will result in delivery delays and customers turning to competitor apps.	1
1.5	The app will need to be tested in a pilot environment before it is launched to the public. Any issues may result in delays with the project.	1
1.6	Sun Food does not seem to have factored variable cost (e.g. delivery fee) associated with the use of the app and delivery into their projections as the gross profit margin remains unchanged in the estimates. Have all applicable costs been considered? (E.g., there are no costs for servers for the software application or maintenance thereof / potential staff training / legal expert / higher electricity & utility bills.)	1
1.7	Existing customers may not have access to mobile phones or internet connectivity required for the app. They may not have credit cards for electronic payment. These customers will be lost to competitors if takeaway branches close.	1
1.8	Many branches of the same franchise brand will be closed. Will existing customers download the new app to order their food or will it be easier to go to competitor branches that have similar menus?	1
1.9	Given the closure of branches, this could impact overall franchisee morale and their employees who will be losing their jobs.	1
1.10	Both branches are in close proximity so it makes sense to consolidate their offering but Sun Food should consider keeping one branch open to serve customers in the area.	1
1.11	The closure of Pizza Pronto and Great Burgers branches will reduce operating leverage, although the opening of a dark kitchen will partially offset the full impact of this.	1
1.12	Now that Covid-19 restrictions have been lifted and the hospitalisation rate decreases, more diners may want to go to restaurants instead of ordering via a delivery app OR there may be a decrease in persons working from home, which could impact demand for the dark kitchen offerings.	1

1.13	Sun Food is exposed to exchange rate risk – ZAR on payment for the investment in the development of the app which could weaken more dramatically than forecast, reducing returns.	1
1.14	What are the working capital implications of the dark kitchen opportunity? These do not seem to have been factored in.	1
1.15	What is the impact on returns (and cash flows) beyond the forecast period? This could impact the probability that the dark kitchen operating model will be expanded post the first phase of implementation.	1
1.16	Will the investment in the dark kitchens potentially distract management from the core offering? This could cause revenues from existing operations to decline.	1
1.17	Given the electricity supply issues in the country, Sun Food needs to consider how energy intensive the dark kitchens will be and if additional support is needed to cope with load shedding, as secure supply is likely to be critical.	1
2	**EatWell (option 2)**	
2.1	The returns from the EatWell investment will be driven by the dividends and final sales price. It is critical that the demand for EatWell meals does not fade until 2025 (how accurate are these forecasts?).	1
2.2	Furthermore, the exit multiple of 6 in 2025 needs to be compared to similar multiples for businesses of a similar operational nature and size to assess reasonability of pursuing an exit at this point or whether it is worth waiting. The business could be more valuable if the market has grown and investors want exposure to this segment.- The multiple of 6 in 2025 needs to be compared to the entry multiple when the initial investment was made, as an increase in the multiple would increase the returns on the EatWell investment.	1
2.3	The meals sold to Sun Food franchises will be pre-cooked and packed. Sun Food should consider whether the proposed distribution model will be suitable for maintaining the quality of the meals from EatWell. Customers may not want EatWell's meals if they are not fresh, especially since they are likely to be health conscious.	1
2.4	If EatWell does not perform well in the next three years, Sun Food may want to sell their stake in the company. If the company is performing poorly, it is likely that the existing owners may not have sufficient resources to pay the value agreed in the purchase agreement. Sun Food may then find it difficult to secure a buyer in the open market.	1 1
2.5	Cookie plays a key role in the success of the business because she is the director of product development. If she leaves, EatWell may lose its competitive advantage and demand for its products may decrease.	1
2.6	The investment in Eatwell potentially positions the business in a new category with strong sustainability credentials. This could be valuable in targeting customers who desire healthier meals with less environmental impact.	1
2.7	The potential synergies of combining the business with Sun Food's distribution capabilities do not seem to have been taken into account.	1
3	**General**	
3.1	Which option consumes more initial capital? It seems as if the investment in option 1 may require more (about 10%) capital but is sensitive to exchange rate movements.	1
3.2	Option 1 is less risky as the payback period is earlier whereas option 2 cash inflows are concentrated to later periods.	1

3.3	Option 2 has a higher IRR, and that would suggest it should be chosen from a purely financial perspective. This needs to be compared to the cost of capital.	1
3.4	Are there alternative investment options that have not been considered? Perhaps shareholders would prefer a return of capital (e.g. by means of a dividend).	1
3.5	Does Sun Food potentially have sufficient cash to make both investments? Given the business had about R40 million of cash on hand as at 31 December 2022, the initial investment for option 2 on 1 January 2023 (R16 million) is likely to take the cash balance below the operational cash balance level of R25 million, which could create liquidity concerns.	1 1
3.6	When one considers that the net assets are worth R 22.8 million (at 30%) or R19 million (at 25%), it seems we are overpaying for the investment, is the goodwill really that much?	1
3.7	Eatwell's directors and SunFood's directors may clash in terms of organisational culture and may not agree on key decisions.	1
3.8	There may be potential tax leakages etc.	1
3.9	CCC has done this before and seen it succeed, their involvement means we will have access to their expertise and experience.	1
3.10	Sun food will have full ownership of the app and kitchen and will be able to make strategic decisions as they deem fit.	1
3.11	The 30% stake in Eatwell only effectively (in substance) gives Sun Food 25% say in the business (can only appoint a director out of 4).	1
3.12	Conclusion: Based on the above, I would recommend Sun Food undertakes the investment in Eatwell, assuming it can only undertake one investment.	1P
	Available	**38**
	Maximum	**19**
	Communication skill – logical argument	***1***
	Total for part (c)	**20**
	TOTAL FOR PART I	**59**