Part (a) Perform a free cash flow to firm valuation of Eurofix to estimate the value of Eurotile's 75% shareholding in the subsidiary • Use earnings before interest and taxation (EBIT) as the starting point in the free cash flow valuation						Marks
Using the forecast cash flows, the following value can be calculated:						
	FY2021 R'000	**FY2022 R'000**	**FY2023 R'000**	**FY2024 R'000**	**FY2025 R'000**	
EBIT		10 340	11 513	12 795		1
Add back IFRS 16 depreciation		1 400	1 400	1 400		1
Deduct market-related rental adjusted for inflation		(1 872)	(1 946)	(2 024)		2
Savings with introduction of robots (20-14) (after VAT) *Award one mark if argued that company is valued without robot project since it is still being deliberated (savings not included)*				6 000		2
		9 868	10 967	18 171		
Tax on EBIT: 28% (Markers: Award the mark if the student debates whether tax will be payable given that the company has assessed losses)		(2 763)	(3 071)	(5 088)		1C
EBIT after tax		7 105	7 896	13 083		
Changes in working capital [C2]		5 359	(899)	(972)		
Subtotal (2024 grow at 5,04% [1])		12 464	6 997	12 111	12 721	1C
Add back depreciation (plant and equipment)		12 856	12 732	14 843	15 718	1
Capital expenditure		(2000)	(5000)	(12 500)	(13 130)	1
Free cash flows		23 050	14 729	14 454	15 309	1C
WACC: 18%						1
*Growth rate: 5,04% [(1,04x1,01)-1]						1P
NPV (year 1 to 3)	46 806					1P
Terminal value	71 895		(15 309)	[18 – 5,04]%	**Disc 3yrs**	2
Value of the firm	118 701					
Less: Value of long-term debt	(70 000)					1
Less: value of short and medium term debt (9 380 + 14 340)	(23 720)					1
Plus: Value of non-core PPE	12 000					1

Plus: Value of preference shares [C1]	5 412					
Value of equity pre shareholders loans	42 393					
Shareholders loans (130m capped at the remaining equity value)	(42 393)					1
Equity value *Although it is seen as debt, the shareholder loan could be considered invested capital. If it is subordinated, it is equity*.	0					1P
C1: Value of the preference shares						
Value = dividend/market related return = 460 / 0,085 = 5 412						1
C2: Changes in working capital						
Inventory	12 790					
Trade receivables	11 160					
Cash	70					
Tax receivable	1 770					
Trade payables	(9 190)					
	16 600					2
10% of sales		11 241	12 140	13 112		1
Movement		5 359	(899)	(972)		
					Available	**25**
					Maximum	**22**
					Total for part (a)	**22**

Part (b)	Prepare a memorandum to Chemen in which you describe the current business and financial risks facing Eurofix that may be used by the directors of Chemen to influence negotiations regarding a potential increase in its existing shareholding in Eurofix. • Calculations are not required.	Marks
Memorandum: Eurofix risk To: Board of Directors, Chemen From: An Accountant Date: 31 July 2021		
1	**The company would need to consider the following with regard to the restructuring:**	
1.1	The company is clearly in distress as it does not seem probable that it will be able to settle its debts as they become due, without these changes.	1
1.2	There is a risk of liquidation if the company does not have cash to settle debts.	1
1.3	Given the solvency and liquidity issues of the company and the time it may take to implement the changes, the company may need to go into negotiations with creditors about their position regarding possible liquidation proceedings. This could lead to strained relationships with creditors, creditors insisting on COD (negative CF impact) and reputational damage.	1
1.4	Given that the replacement of factory workers with robots is a key element in the turnaround strategy, is the senior management of the company sufficiently skilled to manage highly automated processes versus the labour-intensive operations to which it is accustomed? This is especially relevant considering the low investments in research and development in the company	1
1.5	Refinancing risk – inability to acquire new long term/structural debt/ roll current debt at end of term	1
1.6	If the Board approves the decision to replace 200 employees with robots (which is key to bringing the company to profitability), the negative effect of the staff reduction on reputation, worker morale and productivity, and the effect this may have on input costs, should be considered.	1
1.7	Possible industrial action by the unions should also be considered.	1
2	**Even with the restructuring, the directors would have to address the following matters:**	
2.1	The current manufacturing process pollutes the environment and future action of environmental groups, and even legislation that may be put in place, need to be addressed. Risks are additional costs, ruined reputation, etc.	1
2.2	The poor economic growth in South Africa (due to Covid-19 and fiscal debt) may result in the growth forecasts not being met in the short term.	1
2.3	The decreased spend on renovations for the past few years by consumers, as well as eroding margins in the industry results in sustainability risk, less revenue and lower margin will impact the viability of the company.	1
2.4	If competitors become aware of the problems at Eurofix, they may make a concerted effort to get Eurofix's wholesale customers to change over to them.	1
2.5	Interest on loans is paid at market-related variable interest rates. Interest rates are currently very low in South Africa and an increase in rates will put renewed pressure on the cash flow position.	1
2.6	Eurofix does not invest enough in research and development and this may result in its products becoming obsolete.	1

2.7 Customers may prefer shopping at competitors that provide a larger range of adhesive products, which may lead to a loss of sales.	1
2.8 The vinyl sticker market is a viable substitute product that has gained traction in the market, and could pose a threat to the revenue of the company.	1
2.9 The inability of Eurofix to implement the new checkout scanner system resulted in customer dissatisfaction, and therefore customers may move to competitors.	1
2.10 Instances of stock outs due to Eurofix's inability to utilize the big data initiative could lead to lost sales and customers.	1
2.11 Loss of experienced staff may lead to losses, given the time and costs involved in training new staff members.	1
2.12 It may be difficult to attract new staff if the premises seem unsafe because of their location.	1
Available	**19**
Maximum	**10**
Communication skills – layout and structure	*1*
Total for part (b)	**11**

Part (c) Make a recommendation to the board of Eurotile addressing the qualitative and quantitative factors relevant to the two options to either restructure or liquidate Eurofix, as described in section 4. • **Exclude considerations regarding a move to robots.** • **Ignore all tax implications in your calculations.**	**Marks**
1 Restructuring of Eurofix	
1.1 If the shareholders are willing to convert their loans into equity/write off the loans, the company would need to assess whether the saving on the interest relating to the shareholders' loans will generate a sufficient profit/return to address going concern issues.	1
1.2 If the loans are written off, the tax implications would need to be considered as it may result on a waiver of debt for the company.	1
1.3 If the shareholders are unwilling to write off their loans/convert them into equity, more bridging financing may be needed in the interim, which may be expensive and lead to additional gearing.	1
1.4 Restructuring may take some time and creditors might have to be approached to provide space and time to settle accounts.	1
1.5 Will the company be able to cancel contracts and/or what about a moratorium on claims from creditors and loan providers? This could force the company into liquidation as a result.	1
1.6 Eurofix could use the profit from the sale of the non-core assets to reduce its bank overdraft and meet the bank's requirement of reducing the overdraft to R10 million.	1
1.7 Eurofix is highly leveraged, there is a risk that the bank may call facilities up following a breach of other covenants, etc., if profitability does not improve in the short run.	1
1.8 Interest saving will arise from the reduction in debt from the sale of non-core assets for R12 million which could increase profitability.	1
1.9 The estimates for 2022 may not be accurate in view of the outbreak of Covid-19 and it may even have more implications in future.	1

1.10	How certain is it that the non-core assets will be sold at R12 million – has a buyer been identified?		1
1.11	Approaching creditors for a workout arrangement might have an impact on the reputation and ability to secure supply chain credit lines.		1
1.12	The tax effect of the transaction needs to be accounted for.		1
1.13	The utilization of the assessed tax loss may provide an additional source of saving.		1
1.14	What is the impact on employee morale and ability to retain key staff where skills shortages exist and competition remains strong?		1
2	**Liquidation of Eurofix**		
	The restructure value should be compared to the liquidation value, which can be calculated as follows:		
		R'million	
	Value of PPE	98 000	1
	Value of inventory (12 790 x 0,80)	10 232	1
	Value of trade receivables (11 160 x 0,90)	10 044	1
	Value of preference share investments	5 358	2C
	Cash	70	1
	Tax receivable	1 770	1
	Less: Debt		
	Short term	(9 380)	1
	Trade payables	(7 352)	1
	Bank overdraft	(14 340)	1
	Long-term loan	(70 000)	1
	Less: Cost of liquidation	(2 509)	1C
		21 893	
2.1	75% interest in the liquidation value is **R16,4 million**		1
2.2	The shareholders will need to write off all of their loans (R130 million).		1
2.3	Eurotile will have to find new suppliers for adhesive. It may not be easy if competitors have agreements with these suppliers.		1
2.4	The loss of the rent paid by Eurofix on Europrop and the group should be considered, although it could be recovered from the sale of the manufacturing plant. This is an additional cash flow that would need to be considered in the analysis.		1
2.5	The effect on the morale of workers in the rest of the group and how the community will react should be considered.		1
2.6	Any retrenchment costs or vacation leave pay-outs, etc., that may need to be made to employees, may not currently be reflected in the financial statements.		1
2.7	It could have a reputational effect on other areas of the business.		1
2.8	The tax effect of the transaction needs to be accounted for.		1
2.9	Companies act requirements and legal requirements of liquidation proceedings in terms of liquidation should be complied with.		1
	<u>**Overall conclusion**</u> To restructure Eurofix seems most beneficial from an overall perspective and will likely be the least disruption on the supply chain. *Note to markers – Please award mark for directionally correct answer based on factors provided under each consideration*		1

Available	**36**
Maximum	**18**
Communication skills – logical argument	*1*
Total for part (c)	**19**
TOTAL FOR PART I	**52**