	Part (a) Critically evaluate the cash flow forecasts of SMS prepared to assess the company's going concern ability.	**Marks**
1	The revenue growth forecast appears unreasonable given the myriad of ailments suffered by the industry, which are ongoing. The actual change in revenue for FY2020 was -13,2%, a strong contrast to the expectation of 8% revenue growth in the forecast for FY2021. Furthermore, the forecast growth is significantly higher than the inflation rate. There is little evidence to substantiate the growth forecasts in revenue.	1 1 1
2	The revenue from warranties in other income is increasing faster than the overall revenue is increasing. This does not make sense, as logically warranty revenue would be linked to number of vehicles sold	1
3	It appears that the cash flow forecasts as prepared do not explicitly incorporate the potential impact of Covid-19 on SMS' operations, with the potential impact on: (i) customers (medium term demand side pressure as key customers are in industries that have been hit hard by the pandemic), (ii) (ii) employees and the associated costs of meeting revised health/safety standards and (iii) (iii) suppliers (given SMS imports machinery for resale which would likely be impacted by disruptions to shipments, border controls etc.).	1 1 1 1
4	The gross profit margin is forecast to increase by more than the forecast growth in revenue, implying that the growth in cost of sales is less than the growth in revenue which is inconsistent with the rising direct labour costs. How will these cost cuts be effected, without affecting quality or production?	1 1
5	The growth forecast for operating expenses appears reasonable being linked to inflation but not in relation to the forecast growth in revenue	1
6	Growth at inflation rate may also not be reasonable if, for instance, the subsidiary uses a lot of electricity, which is set to increase at a significant rate. The average inflation rate may not be a good predictor for this industry or this business.	1 1
7	The benefit from the assessed loss will reduce the taxation cash flow and should be included, unless it is deemed unlikely to be utilised.	1
8	Is 28% of PBT the correct taxcalculation? Are all depreciation and wear-and-tear allowances aligned, for instance?	1
9	The impairment in FY2020 raises questions as to the reason for the impairment, the effect of the impaired asset on asset productivity, and therefore on (future) profitability.	1
10	The gains on forex by nature are volatile and the recent profits made are speculative in nature and should not be included in the cash flow forecasts. The gains on forex should be adjusted for in the cash flows forecasts to the extent these are not realised and hence are non-cash items. If all amounts are realised, the current treatment is correct.	1 1
11	Perhaps consider rather using a sensitivity/scenario analysis approach to deal with different exchange rate possibilities. Instead of relying solely on information from management.	1
12	**Working capital** considerations: Calculation of relevant working capital ratios:	

		FY2020 | FY2021 | FY2022 | FY2023	
	Inventory days: 219 | 210 | 200 | 180	1P
	Trade receivable days: 45 | 42 | 36 | 36	1P
	Trade payable days: 64 | 65 | 70 | 75	1P
13	Trade payable have already been stretched by increasing over the next three years. Suppliers may be unwilling to keep on awarding credit.	1
14	The effect of this extension will be detrimental to the current ratio and relationships with suppliers.	1
15	The supplier reaction is more likely to be a reduction in terms, moving to cash on delivery, or simply not supplying due to the increased risk.	1
16	The reduction in inventory and debtors' days appears aggressive – what is management's strategy to achieve this, particularly in the current economic environment? (Would incentives have to be provided to customers to pay more quickly?)	1
17	If management considers offering a discount to its customers to reduce the debtors' days – this should be factored into the cash flow forecasts.	1
18	The reduction of debtors' days could lead to a loss in sales, which would affect overall profitability (credit drives sales growth?). How does the debtor's days compare to industry norms? Has provision for doubtful debts been made and what process and policies have been applied?	1 1 1
19	How will the decrease in inventory (especially as it is imported) be effected (20 days in one year). If a new system of procurement is used, has the acquisition cost been factored into the cash flows?	1
20	A dividend in FY2022 and FY2023 will remove much needed cash and liquidity, and consideration should be given to rather retaining the cash flow.	1
21	Have the projected ratios (e.g. GP margin) been compared to industry averages to assess reasonableness? Or historical trends	1
22	There is a risk that SMS may breach key loan covenants, triggering the need to repay some of their outstanding loans and hence the loans repaid line item may be understated.	1
23	Is it reasonable to assume that the bank will extend more credit to the company taking into account the real economic impact of the current times? How was this considered in the cash flow forecasts together with the guarantee provided by Simunye? The fact that Simunye group has been experiencing trading difficulties and reported a net loss for the past two years brings into question whether the guarantee can be relied on.	1 1
24	It isn't clear that forecasted PPE /CAPEX is sufficient to support forecast revenue growth rates and therefore forecast cash flows may be overstated. What are the PPE growth assumptions? Does forecast CAPEX factor in sufficient increases in capacity to meet future growth?	1
	Available	**37**
	Maximum	**14**
	Communication skills – appropriate style	*1*
	Total for part (a)	**15**

© SAICA 2020

Part (b) **Perform a discounted cash flow valuation of Simunye's equity interest in SMS as at 30 June 2020.** • **Use the 'free cash flow to operations' methodology.** • **Start your valuation with the 'Net change in cash and cash equivalents' line item.** • **Assume that the revenue, operating costs and working capital forecasts are reasonable.** • **Round your answer to R million**				**Marks**
	FY2021	**FY2022**	**FY2023**	
	R million	**R million**	**R million**	
Net change in cash and cash equivalents	65	(63)	143	1
Adjustments				
Loans repaid	5	250	500	1
Loans raised	(179)	–	–	1
Dividends paid	–	200	220	1
No adjustment to interest income as cash assumed to be operational	-	-	-	1
Interest paid	358	338	300	1
Tax on net interest (28%)	(100)	(95)	(84)	1
Gain on foreign exchange (non-cash) **OR** reason provided around non-core to operations	(250)	(250)	(250)	1
Tax on foreign exchange (28%)	70	70	70	
Bank overdraft	198	–	–	1
Assessed loss				
FY2021 Taxable income estimate Profit from operations 381 Finance costs (358) Interest income 14 Taxable income 37 (1P) Therefore, R37 million of the R120 million assessed loss can be used in FY2021	10 (1P)			1P 1P
FY2022: same principles as above; there is sufficient estimated taxable profit to use the rest of the assessed loss (R120 million – R37 million)		23 (1P)		1P
Free cash flow	177	473	899	
FY2024 growth (899 x 1.05)			944	1C
Terminal value in FY2023 ((944/ (15,04% - 5%))			9 402	1C
Total cash flow	177	473	10 346	
Discount factor	0,87	0,76	0,66	~~1~~
NPV	**154**	**359**	**6 828**	
Enterprise value (as at 30 June 2020)	**7 341**			1C

© SAICA 2020

Reasonability calculation - **EV/EBITDA valuation (linked to scenario) and/or** - **NAV based valuation (linked to scenario)**				1
WACC				
Cost of debt: 14% (1-28%)	10,08%			1
(20%*1/2+10.08%*1/2)	15,04%			1+1
Enterprise value	7 341			
Less interest-bearing debt	(3 326)			1
Less Overdraft	(198)			1
Add cash (given liquidity challenges assume all cash operational)	-			1
Equity valuation (as at 30 June 2020)	**3 817**			1P
			Available	**23**
			Maximum	**22**
			Total for part (b)	**22**

© SAICA 2020

	Part (c) Describe the actions Simunye could take to address its high gearing levels.	**Marks**
1	The company can make use of a revolving credit facility as a temporary measure, while considering the longer-term recapitalisation of the business (although this would likely be an expensive source of funding).	1
2	The company should consider raising additional equity through a fresh issue, a rights issue (although this would be dilutive especially given a dropping share price), or issuing preference shares.	1
3	The company should continue not paying a dividend due to the tentative current state of the company (and only resume once operations have stabilised).	1
4	The damage of cutting the dividend has already been done. A further negative effect is unlikely based on the current financial position of the business.	1
5	The company could also offer a conversion of debt into equity as a resolution.	1
6	It should be noted that additional equity issued would dilute current shareholders interest significantly as the company would in all probability be doing so most when the share price is depressed.	1
7	The company should seriously consider selling non-performing divisions that are not core to the businesses operations and may be more valuable to an industrial group/investor (with cash flows reinvested in the core operations).	1
8	Simunye should explore merging with another mining company. Additional synergies may arise from the larger mining group, which would assist in profitability (and would be credit supportive). Simunye should explore being acquired by a stronger company seeking to take advantage of the COVID situation to acquire good assets at reasonable valuations	1 1
9	Through a combination with a larger entity, Simunye could gain access to a group treasury function to better manage its liquidity and solvency.	1
10	Debt could be cross-guaranteed in the larger group, de-risking the business.	1
11	The company could sell off other assets like PPE, or where possible explore sale and lease back transactions to raise liquidity.	1
12	The business should explore cost cutting measures as far as possible to improve profitability and operational cash generation to effect faster debt repayment (e.g. Salary freezes, if necessary retrenchments, re-negotiating rental agreement, working capital changes, CAPEX reduction, re-negotiate supplier agreements etc) in light of the current economic environment.	1
	Available	**13**
	Maximum	**8**
	Communication skills – appropriate style	*1*
	Total for part (c)	**9**

© SAICA 2020

	Part (d)(i) Describe the business risks that Simunye is currently facing evident from the scenario		**Part (d)(ii) Provide a mitigating strategy for each of the risks you identified**	
1	*Commodity price risk*: Declines in commodity prices will affect the company directly, as both gold and platinum is quoted in dollar. Simunye is mostly involved in mining operations – very exposed to all risks that have to do with mining.	1	Consider diversifying into other mining, moving out of gold in particular, or mothballing the plant while prices are suppressed or combining with a larger, more diversified mining group Or else take out forward contracts / options?	1
2	*Gold mining risks:* Large part of risks seem to originate from the gold mining operations, as does the losses – this is not sustainable indefinitely	1	Close the gold mining business or restructure operations or consider merger etc	1
3	*Technology and macroeconomic risks:* The global economy is slowing down and demand for platinum is declining. due to changes in cars and a move to electric vehicles (reducing demand for PGMs). SA's credit rating is at a risk of being further downgraded.	1 1	Consider adopting more conservative policies to conserve cash and reduce debt due to risks of global economic slowdown and downgrade of SA's credit rating (which could increase funding costs)	1
4	*Covid-19 related risks:* potential impact on customers (medium term demand side pressure as key customers are likely to be in industries that may have been hit hard by the pandemic e.g. at key subsidiary SMS).	1	Consider adopting more conservative policies to conserve cash and reduce debt due to risks of global economic slowdown as a result of the pandemic.	1
5	*Political risk:* Government interference in the sector is high (changing regulations, such as a mining charter) with risk of additional taxes (such as royalties on minerals).	1	Actively engage with government in shaping legislation that directly impacts the business and ensure that benefits are broadly distributed to stakeholders to reduce risks of 'punitive' super taxes	1
6	*Operational risk:* potential impact on suppliers (given a key Simunye subsidiary (SMS) imports machinery for resale which would likely be impacted by disruptions to shipments, border controls etc.).	1	Consider whether current reliance on suppliers overseas is sustainable and develop relationship with local suppliers if possible or diversify international supplier base by region.	1
7	*Operational currency mismatch risk:* This is particularly relevant where costs/funding are in rand, and revenue in dollar, which creates an additional risk	1	Cannot use hedging instruments (options/futures) as the problem is a long-term one (perhaps only as a short-term measure). It needs to explore natural hedges or rolling forex contracts where possible	1
8	*Operational risk:* **Eskom,** which is currently under significant financial pressure may not be a reliable supplier of power, increasing the risk of power cuts and operational disruptions	1	Simunye should evaluate its reliance on Eskom for power and potentially consider alternative sources of power	1

9	*Operational risk*: Safety incidents in the mine result in staff injuries and legal claims for injuries (or due to impact of Covid-19).	1	The company needs to be more vigilant with safety, create a culture of safety first, develop policies and procedures to manage safety, and implement and enforce such policies and procedures	1
10	*Operational risk*: Mine closures following significant events such as fatalities result in lost production (or due to impact of Covid-19).	1	Staff should be trained on safety, and implementation should be visible. Consider taking out insurance to cover lost revenues due to production disruptions	1
11	*Operational risk*: Strike action and labour unrest is currently occurring, resulting in less production, and possibly also higher salaries and wages costs.	1	Negotiations with the unions is vital. Perhaps initiate a drive to bring the unions in as a partner, and disclose the profitability of the company to explain the dire circumstance and limits on being able to increase salaries and wages. Share incentive scheme in addition to normal remuneration in order to incentives employees in the long term and avoid strike actions in the short term.	1 1
12	*Funding risk:* The company has strict covenants to adhere to, and it is close to these covenants, with a high risk of solvency issues if these are breached (particularly in FY2020) The high debt (and low liquidity) levels create going concern risks particularly in the context of operational challenges and the macroeconomic backdrop.	1 1	The company needs to recapitalise, possibly with equity, a rights issue, or perhaps preference shares	1
13	*Going concern/funding/liquidity risk:* A covenant agreement is mentioned, but not yet agreed to. This is a huge risk to going concern if banks do not agree to rollover facilities	1	The extension of the debt facilities should be put in place formally. Also consider alternative, longer-term sources of funding (e.g. equity), cost cutting, large-scale restructurings and disposal of non-core assets	1
14	*Potential occupational healthcare obligation/legal risk:* Court papers have been served on the company intensifying this risk, and there is a probable class action suit	1	The health and safety environment needs to be audited and amended. Strict enforcement of policies and procedures, and thorough training of staff should be implemented. Simunye should seek legal advice and consider settlement	1
	Available	**16**	**Available**	**15**
	Maximum	**8**	**Maximum**	**8**
			Communication skills – layout and structure	*1*
			Total for part (d)	**17**
	TOTAL FOR PART I			