Diploma in Financial Management

Module B

PROJECT DB2, INCORPORATING SUBJECT AREAS
- **FINANCIAL STRATEGY**
- **RISK MANAGEMENT**

All questions are compulsory and MUST be answered

The project MUST be written in English.

The maximum word count (including appendices and tables but excluding references and bibliography) is 5,000.

The project MUST be TYPED in black ink, one-sided, double-spaced, using a minimum 12-point font size and a 1-inch margin at each side. HANDWRITTEN SUBMISSIONS WILL NOT BE ACCEPTED. The project must be submitted by post, electronic submissions are not acceptable.

The project should be submitted on A4 paper with your student number, project name, date and page number at the top of each page.

A project submission form MUST be completed for each project submitted and attached to the front of the project.

The Association of Chartered Certified Accountants

This is a blank page.
The project begins on page 15.

Section 1 – incorporating subject areas – Financial Strategy and Risk Management.

This ONE question is compulsory and MUST be attempted

Barra Airways plc

1 David Barra, a wealthy entrepreneur, formed Barra Airways in 1978 and floated the company 10 years later on the London Stock Exchange. The company began as a charter airline working for UK travel operators that offered package holidays to Spain, Italy and Portugal. However, following a number of years of indifferent financial performance, David Barra decided that there was no real future in the charter airline business and that a new direction for the company was required. In 1992 he relinquished his role as Chief Executive Officer (CEO) to become non-executive Chairman of the company and appointed Alec Kintyre as CEO of Barra Airways plc. The first and most important task of the new CEO was to reposition the company within the airline industry.

After considering different strategic options, Alec Kintyre decided that the future of the company lay in providing cheap, scheduled flights within Western Europe. The model for this idea came from Southwest Airlines, which offered such flights within the United States. The approach used by Southwest Airlines had proved to be highly successful and its shares were among the best performing shares of US companies over the last thirty years. Alec Kintyre was convinced that the success of Southwest Airlines could be replicated in Europe. He believed that there was a tremendous unfulfilled demand for cheap air travel and that both recent and proposed changes in the competition rules governing the airline industry within Europe would allow newcomers to exploit this demand.

The basic business model adopted by the company has three key features:

(1) high asset utilisation,
(2) low prices and
(3) low costs.

The first feature, high asset utilisation, demands that the company's aircraft have as many scheduled flying hours as possible. The CEO is fond of pointing out that it is only when the aircraft are flying that they are generating revenue. Thus it is quite common for aircraft to be scheduled for five or six short-haul trips per day. The second feature, low prices, means that prices to passengers are much lower than those of the traditional flag carriers such as British Airways or Air France. In order to stimulate traffic volumes, prices are often 20–30% of those of major airlines and sometimes they are even lower. However, on the back of the high volumes created by offering low prices, the company has successfully generated significant ancillary revenues through the sales of goods and through links with car rental businesses and hotels.

In order to be able to offer low prices, there is very tight control of costs. To keep staffing levels (and costs) low, a 'no frills' service is offered to customers. This means that no meals are served on the aircraft (although drinks and sandwiches may be purchased) and seats are not assigned to passengers. Instead, passengers must choose their own seats. The company sells seats over the internet and this now accounts for more than 90 per cent of all seat sales. The on-line booking service means that there is no need to employ staff to issue tickets or to take passenger details. The low-cost culture of the company puts pressure on staff at all levels. Challenging targets are set and high levels of productivity are expected. Trades unions are not formally recognised and pilots are required to work near to the monthly maximum flying hours imposed by law.

The commitment to keeping costs low means that the major airports within Western Europe are not used. Instead, the company has landing agreements with secondary airports. These are often former military airports situated some miles from the destination city. As a result, passengers have more travelling time than if the major airports were used. Although this is often not a problem for those travelling for leisure purposes, it can be a problem for those travelling for business purposes. However, the advantages of using secondary airports are that they are less congested and this allows the aircraft to land and take off again within thirty minutes, thereby increasing their revenue-earning potential. Landing charges are also much cheaper than for the major airports.

Barra Airways plc began its new venture by buying a small fleet of new Boeing 737-200 aircraft. However, the company has now outgrown this fleet and has recently decided to replace the existing fleet with a much larger fleet of Boeing 737-800 aircraft. These aircraft can carry 189 passengers, rather than 130 passengers for the Boeing 737-200, thereby providing greater revenue-earning potential per trip. The decision to have only one type of aircraft in service was driven by cost considerations: the costs of servicing are reduced and carrying costs for spares are also reduced.

By the end of September 2004, the company's shareholders had good reason to be pleased with the decision to turn the company into a low-cost airline. It had mounted a successful challenge to the markets that was previously dominated by the traditional flag-carrier airlines and had also helped to create new markets for cheap flights. The company was now a force to be reckoned with in Western Europe with flights to more than 30 destinations. The profit and loss accounts of the business for the past three years are set out below.

Profit and loss accounts for the year to 30 September

	2002	2003	2004
	£m	£m	£m
Revenue from seat sales	345	415	522
Ancillary revenues	35	42	52
	380	457	574
Employee costs	(52)	(67)	(81)
Fuel and oil	(54)	(68)	(95)
Maintenance	(15)	(22)	(25)
Depreciation	(48)	(51)	(52)
Marketing	(25)	(23)	(20)
Route charges	(28)	(35)	(48)
Airport charges	(45)	(59)	(79)
Miscellaneous expenses	(18)	(13)	(30)
Operating profit	95	119	144
Net interest charges	(20)	(14)	(18)
Net profit before taxation	75	105	126
Corporation tax	(25)	(31)	(30)
Net profit after taxation	50	74	96

The company is committed to maintaining a strong balance sheet. The company owns all its own aircraft and has healthy cash and near cash balances to meet future commitments. The abridged balance sheet as at 30 September 2004 is as follows:

	£m	£m
Fixed assets		635
Current assets		
Stock	19	
Debtors	10	
Cash and cash equivalents	514	
	543	
Less: creditors due within one year		
Trade and sundry creditors	215	328
		963
Less: creditors due beyond one year		
Long-term loans		385
		578
Capital and reserves		
Ordinary shares		100
Reserves		478
		578

Alec Kintyre was determined that the company should maintain its growth momentum. He recognised that the low-cost airline market was still in its infancy and that there was still considerable growth potential within Western Europe. Low-cost flights in Western Europe still only accounted for around 16% of the total air passenger market compared to around 23% in the United States. However, competitive pressures were mounting. There was an increasing number of low-cost airlines competing for market share and the traditional flag carriers were lowering prices on certain short-haul routes in order to maintain their market share. Furthermore, high-speed trains in Europe were mounting a concerted campaign to attract passengers. Alec Kintyre was therefore looking for new markets to exploit.

He believed that there was an enormous untapped market in European countries that were formally part of the Eastern bloc. Rising living standards within these countries and the trend towards EU enlargement convinced him that the long-term future of low-cost flights lay in opening up new routes to countries such as Latvia, Estonia, Lithuania, Slovenia, Romania and Bulgaria. A recent report from the EU produced the following figures concerning the estimated population changes in Eastern Europe (excluding the Russian Federation).

	2005	2006	2007	2008	2009	2010	2011	2012
Eastern Europe population (millions)	165·3	164·5	163·1	162·2	161·8	160·5	158·4	158·1

After 2012, it was forecast that the population would stabilise at the 2012 figure for at least 10 years.

Another recent report by Jura Associates, an equity research firm, predicted that the number of low cost flights per capita within Western Europe would be as follows:

	2005	2006	2007	2008	2009	2010	2011	2012
Low-cost flights per capita	0·18	0·21	0·28	0·34	0·35	0·42	0·48	0·52

Beyond 2012, it was felt that the low-cost airlines would face intense competition from the major airlines and passenger trains and so no further growth was likely. There were no reliable estimates as to what the number of low-cost flights per capita in Eastern Europe would be over the same period. However, in a recent equity briefing to investors, Jura Associates argued that a realistic estimate would be 60% of the above figures.

Barra Airways was one of the first low-cost airlines established within Western Europe and this helped in gaining market share. Alex Kintyre believed that the same strategy was required with Eastern Europe. The company had been negotiating for some time with airport authorities in a number of different Eastern European countries and 20 new routes could be established immediately. It was also possible for the company to take immediate delivery of 20 Boeing 737-800s to service these routes as the manufacturer had recently suffered a cancelled order from another airline. Each route would have a new aircraft assigned to it offering four, one-way flights per day in the first six years of operations rising to six, one-way flights per day thereafter. These flights would be offered on each day throughout the year.

Barra Airways plc estimated that, as an early mover into the new market, it would gain a significant market share in the early years. However, competition is expected to bring this market share down, at least until additional trips are added to the schedules in 2011. The following estimates of the market share of Barra Airways plc for Eastern European low-cost flights were produced by Tiree and Coll Ltd, a company that specialises in consultancy services to the airline industry:

	2005	2006	2007	2008	2009	2010	2011	2012
Market share (%)	20·0	18·0	15·0	13·0	12·0	11·0	13·0	13·0

After 2012, the market share for Barra Airways plc was expected to remain at 13 per cent.

Barra Airways plc has a reputation for having a high percentage of seats sold on every trip. (This percentage is known as the load factor). It is believed that high load factors could be achieved on Eastern European routes providing seat prices were competitively set. The company has produced the following estimates of load factors and average seat price for Eastern Europe as follows:

	2005	2006	2007	2008	2009	2010	2011	2012
Load factor (%)	65	68	70	72	72	74	76	78
Average seat price	£30	£32	£35	£35	£40	£42	£44	£48

After 2012, load factors and seat prices are likely to remain at 2012 levels.

Barra Airways plc believes that operating profit margins for the Eastern European routes will be similar to those obtained for the Western European routes. Although certain expenses were likely to change as a proportion of total sales over time, this would be cancelled out by changes in expenses elsewhere and so operating profit margins would be unaffected.

By buying the Boeing 737-800s in bulk, the company expects to pay a discounted price of $35 million for each aircraft. Furthermore, the company is confident that it can negotiate payment in three equal instalments: an immediate payment followed by further payments at the end of 2005 and 2006. For each aircraft purchased, a major engine and airframe overhaul will be carried out by the Boeing Corporation after eight years at an approximate cost of $10 million per aircraft. However, this amount is pre-paid and included as part of the cost of the aircraft mentioned above. The cost of the aircraft, excluding the major maintenance charge element, is written off over the useful life of the asset and the maintenance charge element is written off over the shorter period between the purchase date and the end of the year of the major overhaul. This policy is in accordance with current financial reporting standards.

Each aircraft has an estimated life of 20 years and, at the end of its useful life, the residual value of an aircraft is estimated to be $5 million. Barra Airways plc has a policy of depreciating aircraft over their useful life using the straight-line method. (This is also used for the tax calculation). The company will finance the purchase of the new aircraft partly by the use of its cash resources and partly by the immediate issue of £250 million of 6·0% fixed-rate loan capital over twenty-five years. No further aircraft will be purchased for the Eastern Europe routes beyond those mentioned above. At the end of the life of the aircraft, a decision will be made as to whether to continue operations in Eastern Europe.

Alec Kintyre was due to address the Board of Directors of Barra Airways plc in a few days' time. At that meeting the Board would consider the proposed expansion plans and make a decision. Alec Kintyre and the other Board members were keenly aware that the company had received considerable praise from the investment community for the way in which it had performed to date. However, the proposed plans represented a major investment that could have a profound effect on the future of the business. The goodwill of investors could be lost if things did not work out as planned. It was absolutely vital, therefore, that the figures presented to the Board meeting were as reliable as possible and that all the risks of the new venture were properly identified and evaluated.

The assessment of risk gave Alec Kintyre particular concern. He felt that the company's risk management procedures were not yet fully developed and that the internal audit department of the company could play a bigger role in this area. At present, the internal audit function was confined to checking the controls in place with respect to accounting transactions. However, this narrow role was considered by Alec Kintyre to be both inadequate and outdated given the changes in corporate governance procedures that had occurred in recent years.

The company uses the net present value method and the payback method to evaluate new investment proposals. It has a weighted average cost of capital (WACC) of 8% but there is some uncertainty as to what impact the proposed expansion programme will have on this figure. Most independent investment analysts believe that operations in Eastern Europe are more risky than those in Western Europe. The consensus seems to be that a further 2% should be added to the WACC to take account of this, although a few have argued that a 3% adjustment is needed. Alec Kintyre, however, believes that the operational risks in Eastern Europe are not significantly higher than in Western Europe.

Assume that the corporation tax rate is 20% of operating profits.

Required:

(a) Prepare a report for the Board of Directors of Barra Airways plc concerning the proposed expansion plans. In the report you should:

(i) calculate the net present value and payback period of the proposed plans; (18 marks)

(ii) re-calculate the net present value and payback period using an alternative approach to predicting the incremental cash flows to act as a check on the reliability of the calculations provided in your answer to (i) above; and (18 marks)

(iii) calculate the sensitivity of the net present value calculations in (i) and (ii) above to the possible options relating to the weighted average cost of capital. (6 marks)

(b) Comment on the results of your calculations in (a) above. (6 marks)

(c) State what additional information would be required before a final decision is made as to whether the plans should go ahead. (8 marks)

(d) Identify and assess the risks that are associated with the proposed plans. (16 marks)

(e) Provide a risk map for the proposed expansion plans and suggest policies for dealing with the risks that have been identified. (18 marks)

(f) Comment on the point made by Alec Kintyre concerning the internal audit department and discuss the role that the department might play in the management of risk. (10 marks)

Notes.

1. All recommendations must be supported by reasoned arguments.
2. All key workings must be shown and key assumptions must be clearly stated.
3. Workings should be in £millions and should be to one decimal place.
4. Ignore inflation.
5. Assume an exchange rate of £1 = $1·60
6. Assume that corporation tax is paid during the year in which the tax liability arises.

(100 marks)

End of Project