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

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

This ONE question is compulsory and MUST be attempted

Capella Leisure Ltd

1 Capella Leisure Ltd was formed in 1976 by David and John Capella in order to exploit the growing demand for skiing holidays. The Capella brothers ran the business successfully until 1997 when they decided to retire and sell the company. At that point, Capella Leisure Ltd became a wholly-owned subsidiary of Alhena Holidays plc. Until this change of ownership, the company focused exclusively on providing package holidays from the UK to ski resorts in France, Switzerland and Italy. However, since 1997 it has diversified its business to include the operation of a dry ski slope centre in Wales. Dry slope skiing involves skiing on specially designed plastic matting and offers an opportunity for skiers to practise their skills when no snow is available. The parent company is dedicated to maximising shareholder wealth and views the move into dry slope skiing as a potential growth area.

The draft financial statements of Capella Leisure Ltd for the most recent year are as follows:

Draft balance sheet as at 31 January 2004

	£000	£000	£000
Fixed assets (at written down values)			
Freehold office premises			450
Leasehold land and buildings			1,660
Tour coaches			174
Fixtures and fittings			85
Dry slope matting			340
			2,709
Current assets			
Stock of hire equipment		60	
Other stocks		15	
Cash in hand		3	
		78	
Less **Creditors: Amounts due within one year**			
Bank overdraft	5		
Trade creditors	182		
Other creditors including customer deposits	106		
Dividends	218	(511)	(433)
			2,276
Less **Creditors: Amounts due after more than one year**			
6% Loan stock (secured on freehold and leasehold buildings)			800
			1,476
Capital and reserves			
£0·50 ordinary shares issued			300
Retained profit			1,176
			1,476

Draft profit and loss account for the year ended 31 January 2004

	£000	£000
Sales		7,350
Cost of sales		3,790
Gross profit		3,560
Less:		
Selling and distribution expenses	1,424	
Administration expenses	1,652	3,076
Operating profit		484
Finance expenses		48
Net profit for the year		436
Dividends payable		218
Retained profit for the year		218

The company has forecast that it will achieve an 8% increase in total sales during the forthcoming year. (This forecast does not include the effect on sales of any new ventures undertaken during the year.) However, past experience has shown that achieving the forecast is no easy task and that much will depend on the state of the economy. Skiing holidays tend to be sensitive to general economic conditions and so actual total sales could be as much as 10% higher or lower than the forecast figure.

The company must replace existing fixed assets at a cost of around £240,000 per year for sales up to the forecast figure and will incur further costs of £200,000 for additional tour buses if total sales turn out to be higher than the forecast figure. It is estimated that 30% of the total operating expenses (i.e. cost of sales, selling and distribution expenses and administration expenses) of the business are variable and that 70% are fixed. The fixed cost expense element includes depreciation charges of £260,000 for the year to 31 January 2004 and this will remain unchanged in the forthcoming year providing actual sales are not higher than forecast. (This figure takes account of the depreciation of replacement fixed assets mentioned above.) However, if sales are higher, an additional depreciation charge of £25,000 will be required to take account of the purchase of new tour buses.

The dry ski slope centre was purchased by Capella Leisure Ltd in 1997 from a business in financial difficulties. The centre was in poor condition when first acquired and the company invested heavily in new equipment and facilities. This investment has yielded benefits and the main ski slope is now reaching the point where it is unable to cope with the volume of visitors at peak times. In recent years, the growing popularity of snowboarding has led to an increase in demand for dry slopes and snowboarders now account for 35% of the total number of visitors to the centre. At present, snowboarders are accommodated on the main slope on particular days and times. However, the company is considering building a new slope that will be dedicated to this new sport. This will allow snowboarders much greater access to the centre. To date, the company has incurred £25,000 in market research and surveyors' fees to investigate the feasibility of building the new slope.

The dry slope centre is built on land that has been leased from a local farmer. All of this land is currently being utilised to accommodate the centre, which consists of a main slope, two beginners' slopes, a bar, a clubroom and workshop facilities. However, the farmer has agreed to lease further land to the company, which adjoins the existing land being leased, for an eight-year period. At the end of this period, the farmer intends to sell the land to the highest bidder. Although the land available for leasing already has a hill, it does not have the right gradient for a dry slope and so some construction work would be required. Once the construction work is complete, the hill must be covered in plastic matting for snowboarding and a water sprinkling system installed, both for lubrication purposes and to help protect the matting. The land is awkwardly situated and so a new access road and additional car parking facilities would be required.

The existing slopes at the centre use plastic matting that was first developed in the 1960s. Although many dry ski slope centres continue to use this form of matting, it is not popular with visitors as it provides a hard landing for those who fall. If a new slope is built, a more recently developed form of matting, which is made of a new type of plastic and laid upon foam, will be used as it provides a much softer landing. The supplier of this new form of matting claims that it will have to be renewed after three to five years. Capella Leisure Ltd investigated these claims and found that two dry ski slope centres in Ireland, which were among the first to use this new form of matting, renewed the matting at the end of four years.

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The following set-up costs for the new slope have been estimated for the year to 31 January 2005:

	£
Plastic matting	355,000
Water sprinkler system for the matting	82,000
Chair lifts	106,000
Alterations to gradient of land	174,000
Construction of access road and drainage	165,000
Additional car parking facilities	75,000

All the above costs will have to be paid at the end of January 2005 and the figures shown represent the best estimates that can be obtained. However, the surveyors have warned that there may be problems relating to drainage of the land and that this could add a further £70,000 to the construction bill. Any drainage problems that exist will not be fully identified until construction begins. The new car parking facilities that have been planned will be sufficient to accommodate 30,000 extra visitors to the centre each year. If more visitors than this figure are expected, further car parking will be required at a cost of £30,000.

The new type of plastic matting that is to be used on the slope is available from only one supplier, which is based in Scotland. Although the supplier has stated that it should be able to deliver the matting when required, it is currently working to full capacity and its order book is full. Capella Leisure Ltd is concerned that, if a firm order is placed, a delivery date will be offered that is unacceptable. If the supplier cannot deliver on time, another supplier based in the US can provide ski slope matting, which is broadly similar to the matting required, for $600,000 and prompt delivery is guaranteed. However, this matting will only last for $2^1/_2$ to 3 years and is regarded by the company as a less attractive option. When the time comes to replace the matting, it would be possible to use the supplier based in Scotland as delivery dates would not be so critical and the purchase could be planned further in advance.

Work on the new slope will only commence after planning permission has been obtained. Although no formal planning application has yet been submitted, there have been preliminary discussions with the planning department of the local council. These discussions indicated strong support for the proposal within the council, which suggested that planning permission would be granted. However, in the unlikely event that the planning committee, which will make the final decision, raises objections to certain aspects of the proposal, modifications to the plans may have to be made. This could lead to a delay of up to one month in obtaining planning permission. Although it is difficult to predict what modifications the planning committee may require, the maximum cost of making modifications is estimated to be £10,000.

Assuming that there are no objections to the planning proposals and the construction work proceeds smoothly, the new slope is expected to open on 1 February 2005. However, the surveyor has warned that, if there are drainage problems, a delay of two months in completing the construction work is likely to occur. This delay is in addition to any delay in obtaining planning permission and would represent a real setback for the company. Demand for the ski slope is highly seasonal as skiers often wish to practise their skills immediately before a ski holiday taken in the winter months. As a result, the early months of each calendar year are very popular. The following table, based on information collected by the company over the past five years, shows the percentage of the total annual visitors using the centre each month:

Month	**Percentage of total annual visitors**
January	13
February	22
March	17
April	11
May	5
June	2
July	1
August	2
September	4
October	5
November	7
December	11
	100

If the company decides to go ahead with the investment, it will increase its marketing budget by £120,000 in the first six months that the slope is in operation. In addition, an eight-year lease agreement will be signed for the land in early February 2004 at a cost of £65,000 per year, payable at the beginning of each year.

The findings of the market research commissioned by the company indicates that the additional slope will boost the number of visitors to the centre by 28,000 in each of the first three years to 31 January 2008 and, for the period from 1 February 2008 until the end of the lease, the number of visitors is likely to be 22,000 per year higher than the current number. The market research report also indicates that, after the end of the lease period, visitor numbers will be higher than would have been the case if a new slope had not been built. The report states that a significant number of snowboarders using the dedicated slope, who had not visited the centre before the opening of the new slope, will migrate to the main ski slope after the closure of the snowboarding slope. It is estimated that there will be about 5,000 extra visitors per year using the main ski slope over the five-year period following the end of the lease. However, all the estimates within the market research report contain a possible margin of error of ± 20%.

Although the main source of revenue from the new slope will be in the form of entrance fees, there are likely to be other revenues arising from opening a new slope. The company offers hire facilities for snowboards and boots as well as lessons in snowboarding from qualified instructors. The additional influx of visitors to the dry slope centre is also likely to increase bar and clubroom receipts. Information concerning current revenues, prices and usage is as follows:

	Revenues/prices per customer	**Usage**
Hire of snow boards and boots	£7·00	1 in 5 visitors
Snowboard instruction	£30	1 in 20 visitors for one hour's instruction each.
Bar and clubroom facilities	£5	1 in 2 visitors
Entrance fees	£15 adult £12 Junior (under 16)	

Snowboarding is particularly popular among younger people and, currently, 60% of all snowboarders visiting the centre are less than sixteen years of age.

Additional costs of operating another slope are expected to be as follows:

– An additional stock of snowboards and boots for hire, costing £6,000 will be required at the end of January 2005. Assuming that there are no more than 30,000 extra visitors each year, stock will have to be renewed three times per year for each year that the new slope is open. However, if the number of visitors exceeds 30,000, the replacement will have to be four times per year. No additional stocks will be required after the end of the lease period.

– Food and drinks available in the bar and clubroom are estimated to cost 50% of their selling price.

– Snowboard instructors are paid on an hourly basis at a rate of £12 per hour. Those visitors having instruction have a one-hour lesson only.

– Additional electricity and power costs are estimated at £20,000 per year for each year the slope is open.

– Additional annual wages for operational and maintenance staff are estimated at £45,000 for up to 30,000 extra visitors per year. However, if there are more visitors than this, further part-time staff costing £15,000 per year will be required.

The parent company, Alhena Holidays plc, exerts tight control over new investments made by its subsidiaries. The general policy to be followed by a subsidiary is that any new investment must be financed from its available cash. In exceptional circumstances, however, it will consider an application from a subsidiary to raise finance from other sources. If the application is accepted, this will only allow the subsidiary to seek external sources of long-term finance for any shortfall in funding requirements, Alhena Holidays plc will not fund the projects of its subsidiaries either directly, by the introduction of new finance, or indirectly, by a change in the dividend payout ratio of the subsidiary. Furthermore, Alhena Holidays plc will not agree to any external funding that involves the issue of equity share capital. In view of this last restriction, the management of Capella Leisure Ltd is considering either a loan from a bank at a variable rate of interest of 7% or an issue of 8% preference shares in order to help finance the proposed investment. However, the company has yet to investigate fully the issues associated with each form of finance.

Capella Leisure Ltd has found that the US supplier of plastic matting invoices in US$ and will require payment in full at the end of January 2005. The current spot rate is £/$1·6045 and a leading bank has predicted that the £ sterling will weaken against the US dollar by between 4 and 6% over the next year. The company has yet to decide how to deal with the payment to the US supplier.

When subsidiaries provide Alhena Holidays plc with investment proposals, the parent company has specified that the net present value method and the payback method must be used for appraisal purposes. (The cost of capital for Capella Leisure Ltd is 12 per cent and the required payback period is 5 years.) Alhena Holidays also insists that investment appraisal includes scenario analysis based upon an optimistic, a pessimistic and a most likely scenario in terms of future outcomes. Finally, all investment proposals must be accompanied by an assessment of the key risks associated with the proposal and the ways in which these risks will be managed.

Required:

(a) Evaluate the investment proposal in accordance with the requirements of Alhena Holidays plc and provide a preliminary recommendation concerning acceptance or rejection of the project. (36 marks)

(b) Comment on the requirements of Alhena Holidays plc for evaluating investment proposals and state any recommendations that you would make for improvement. (8 marks)

(c) Identify the key risks associated with the investment and financing proposals and suggest ways in which these might be managed. (20 marks)

(d) Identify further information that Alhena Holidays plc is likely to require concerning the monitoring, planning and control of the project before a final decision is made. (12 marks)

(e) For the optimistic, pessimistic and most likely scenarios, calculate the expected profit or loss for the year ended 31 January 2005 and prepare a projected cash flow statement for the year ended 31 January 2005 to show the amount of funding to be raised from external sources. (15 marks)

(f) Discuss the factors that should be taken into account when deciding between the two financing options identified. Which option would you recommend and why? (9 marks)

(100 marks)

Notes:

In answering the case study question:

1. Assume that it is now 1 February 2004.
2. All recommendations must be supported by reasons.
3. All key workings and assumptions must be clearly stated.
4. Workings should be in £000's and should be to one decimal place.
5. Ignore taxation and inflation.

End of Project