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 table of contents, 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

Barchester Rovers Football Club

1 Barchester Rovers is a professional football club which boasts a long and distinguished history. Formed in 1890 and located in the south of England, it has achieved considerable success in both domestic and European football competitions. The most successful period occurred in recent years when under the stewardship of its gifted and charismatic manager, Brian Framlington, the club won three English Premier League titles, the FA Cup and European Cup. This run of success, however, came to an end during the 2004/5 season when the manager suddenly resigned following a dispute with the directors.

The club was thrown into crisis by this event and a frantic search for a replacement took place. A new manager, Jack Casterbridge, was finally appointed and, as an incentive to take the job, he was given a budget of £60 million with which to purchase new players. He argued that many of the players acquired during Framlington's reign were coming to the end of their careers and that new blood was required. The budget available for new players was soon spent, but subsequent events showed that it had not been spent wisely. The players acquired came from Italian and Spanish clubs and proved unable to adapt to the fast-paced and physical side of play found in the English Premier League. Pressure for success was intense and, following a series of poor team performances, the directors decided to dismiss Casterbridge.

Although another manager was immediately appointed, he was unable to halt the decline in the club's fortunes. Disappointing performance followed disappointing performance, which led eventually to the club being relegated to the Championship League at the end of the 2004/5 season. The directors realised that relegation to this lower league would be a financial disaster for the club. They had agreed a generous budget for new players on the assumption that the club would maintain its Premier League status and would be in a position to challenge for domestic and European honours. The acquisition of new players had been financed by taking out a large loan and the consequent interest payments, along with the high wages agreed for the new players, were unsustainable in a lower league.

Revenue fell dramatically during the 2005/6 season as a result of lower attendances at matches, withdrawal of sponsorships and a fall in income from merchandising and television rights. Total revenue represented a little more than half of what had been generated in the preceding season even though the cost base of the club remained broadly the same. In an effort to relieve the financial burden, an attempt was made to sell some of the new players but other clubs were not prepared to pay the prices demanded. As a result, the wages bill was not reduced and it represented 80% of the total revenues for 2005/6. The lack of financial success was mirrored on the football pitch where the team ended the season near the bottom of the Championship League and only narrowly avoided further relegation.

Barchester Rovers is a public limited company that was listed on the London Stock Exchange in 2001 amidst a huge fanfare of publicity. At the time of the flotation, the club had achieved a notable 'double' by becoming Premier League champions and FA Cup winners in the same season, which led the issue of shares to be hugely oversubscribed. At the end of the 2005/6 season, however, the gloom of Barchester Rovers' equity investors matched the gloom of its fans, with shares in the club quoted at £1·02 each, compared to a flotation price of £3·40 per share.

The abridged financial statements of Barchester Rovers Football Club plc for the year to 31 July 2006, which covered the whole of the 2005/6 season, are set out below:

Income statement for the year to 31 July 2006

	£m	£m
Revenue		42·2
Operating expenses		
Players' wages	33·8	
Amortisation of players' registrations	12·9	
Depreciation	4·2	
Administration and other operating expenses	10·2	61·1
Profit (loss) before interest and taxation		(18·9)
Interest payable		(4·2)
Profit (loss) after interest and taxation		(23·1)
Corporation tax		–
Net profit (loss) after taxation		(23·1)

Balance sheet as at 31 July 2006

	£m	£m
Non-current assets		
Property, plant and equipment at cost	114·8	
Less Accumulated depreciation	20·2	94·6
Players' registration at cost*	75·0	
Less Amortisation**	33·0	42·0
		136·6
Current assets		
Inventories	1·6	
Receivables	8·2	
Cash at bank	5·0	
	14·8	
Less Current liabilities		
Payables	13·2	1·6
		138·2
Less Non-current liabilities		
Bank loan		60·0
		78·2
Equity		
£0·25 Ordinary shares		10·0
Share premium		126·0
Retained profits (losses)		(57·8)
		78·2

* This represents the cost of acquiring players who are under contract with other clubs. To acquire a new player who is currently under contract, a payment often has to be made to the club that holds the player's contract.
** The cost of acquiring a player's contract is depreciated (amortised) over the period of the contract.

By the end of the year to 31 July 2006, the club was in a precarious financial position. There had been a serious breach of the loan covenants and the bank had requested an urgent meeting with the directors. Furthermore, the wage bill was proving a huge financial strain that could not easily be reduced as many of the players were under lengthy contracts. The club faced the risk that it would be forced into liquidation unless it could be rescued from its predicament.

During this period of financial crisis, the club was being carefully monitored by Chris Ambridge. Chris is a successful businessman who made his fortune from running a large hedge fund business. He was born in Barchester and has been a life-long fan of the club. Although dismayed by recent events, he recognised that an opportunity existed to help the club and to make a good investment. Chris was confident that, over the medium term, he could transform the fortunes of the club both on and off the pitch. In August 2006, he therefore made an approach to its directors to take over the club. Chris was heartened by the response from the club's directors to his approach but knew that the finance required for his plans was beyond his means alone. To ensure adequate financial backing, he put together a consortium of businessmen for the proposed venture.

A meeting of the new consortium was called in August 2006 and, at that meeting, Chris unveiled the key elements of his strategy for reviving the club's fortunes. The starting point was to improve the performance of the team. He argued that football success would drive commercial success and that a virtuous circle would be created if the proceeds of the latter were re-invested in the football team. To begin the process of improving team performance, Chris proposed bringing back Brian Framlington to manage the team. In secret discussions held in a London hotel, Brian had agreed to return to the club. Brian, however, was currently under contract with another club and compensation of £2m would have to be paid to his employers at some point during the 2006/7 season in order to allow Brian to return to Barchester Rovers. During the secret discussions, Brian insisted that money would have to be made available to rebuild the team. It was, therefore, agreed that £50m should be made available during the 2006/7 season and a further £30 million should be available during the 2007/8 season to spend on players. Brian was keen to sell the players who had been brought in since his departure and it was estimated that £25m could be raised during the 2006/7 season from this source. Although a huge loss would result from the sale of these players, it was considered an essential pre-requisite to the revival of the team.

The second element in the revival of the club's fortunes involved the redevelopment of the stadium, which occupies a prime site near the centre of the city of Barchester. There is a significant amount of land adjoining the stadium currently being used as a training ground. Chris outlined a plan to move the training ground to a venue on the outskirts of the city and to use the vacated land to build:

- sports facilities for the local community;
- new hospitality facilities including valet parking and concierge facilities;
- conferencing and event facilities;
- retail and restaurant facilities;
- a hotel and sports bar.

Other football clubs had undertaken similar redevelopment and Chris felt that the directors of the club had been slow to recognise the potential of the club's assets.

At the meeting, Chris presented the consortium with some initial figures relating to his proposals. He believed that the return of Brian Framlington would provide a huge boost to the club and that this would be reflected in matchday attendances. As a result, revenues from matches would increase substantially compared with the year to 31 July 2006. Chris also believed that the team would regain promotion to the Premier League, although it was uncertain when this would occur.

Table 1 below sets out the forecast revenues from league matches over the next five seasons based on the club retaining its Championship League status.

Table 1
Forecast revenues from league matches: assuming Championship League status

			Season		
	2006/7	2007/8	2008/9	2009/10	2010/11
£m	16·3	17·1	18·0	19·1	20·2

Table 2 below sets out the forecast revenues from league matches if the club returns to the Premier League.

Table 2
Forecast revenues from league matches: assuming Premier League status

	Season in Premier League			
	1st season	2nd season	3rd season	4th season
£m	27·6	28·0	29·5	29·9

In addition to league matches, the club would receive revenue from various cup competitions. As the squad of players is to be strengthened considerably over the next two seasons, this is expected to enhance the prospects of success in these competitions. Table 3 sets out the forecast revenues from cup competitions over the next five seasons based on the club retaining its Championship League status.

Table 3
Forecast revenues from cup competitions: assuming Championship League status

	Season				
	2006/7	2007/8	2008/9	2009/10	2010/11
£m	5·2	7·5	8·5	9·0	10·3

Table 4 below sets out the forecast **increase** in revenues arising from cup competitions, over the relevant season in Table 3, following the club's promotion to the Premier League.

Table 4
Forecast increase in revenue from cup competitions: assuming Premier League status

	Season in Premier League			
	1st season	2nd season	3rd season	4th season
£m	Nil	4·0	4·7	5·5

Revenues from sponsorships, retail merchandising and television rights are also dependent on the league status of the club. Tables 5 and 6 set out the forecast revenues from these sources for both Championship League and Premier League status.

Table 5
Forecast revenues from sponsorships, retail merchandising and television rights: assuming Championship League status

	Season				
	2006/7	2007/8	2008/9	2009/10	2010/11
Revenue					
Sponsorship (£m)	11·0	11·4	11·9	12·2	12·5
Merchandising (£m)	9·1	9·3	9·6	9·8	10·3
TV Rights (£m)	6·2	6·8	7·2	8·1	8·4

Table 6
Forecast revenues from sponsorships, retail merchandising and television rights: assuming Premier League status

	Season in Premier League			
	1st season	2nd season	3rd season	4th season
Revenue				
Sponsorship (£m)	20·5	21·0	22·4	22·9
Merchandising (£m)	11·9	12·5	12·8	13·8
TV Rights (£m)	22·5	23·5	25·2	25·8

The redevelopment of the stadium is expected to take three years and work will commence in August 2007. Initial discussions with contractors indicate that the redevelopment work would be carried out in three distinct stages as follows:

Table 7
Schedule of redevelopment work

Stage	Work to be carried out	Completion date
1	Sports facilities for local community	31 July 2008
2	Conferencing, event and hospitality facilities	31 July 2009
3	Retail, restaurant, bar and hotel facilities	31 July 2010

The total cost is likely to be around £90m and payments will be made at the completion of each stage as follows:

– Stage 1 £40m
– Stage 2 £30m
– Stage 3 £20m

It is expected that a government grant of £10m will be available for part of the work carried out and this will be received during the year 2009/10. The grant relates to the first stage of the development and will reduce the net cost of this stage for depreciation purposes.

The following forecast revenues from rents and other commercial activities will accrue from the additional facilities provided:

Table 8
Forecast revenues from rents and other commercial activities

			Season		
	2006/7	**2007/8**	**2008/9**	**2009/10**	**2010/11**
£m	–	–	3·8	7·9	12·4

Although aware that the operating expenses of the club had to be kept under control, Chris acknowledged that strengthening the squad of players would lead to a higher wage bill. He forecast that the net effect would be to increase the current wage bill by £2m in 2006/7 and by a further £1m in 2007/8. The wage bill would then remain at the 2007/8 level in the following years. He pointed out to consortium members, however, that the increase in revenues resulting from the squad changes would ultimately have the effect of reducing the wage bill as a percentage of total revenues. Chris also acknowledged that administration and other operating costs are likely to rise by 5% each year for the foreseeable future. Furthermore, working capital requirements of the club are likely to increase with increases in total revenues. Additional working capital requirements are expected to be equivalent to 20% of the increase in total revenues during any given year.

The cost of players' registrations is amortised over a five-year period with a full year's amortisation in the year in which a player is acquired and none in the year of sale. Depreciation of existing property, plant and equipment is expected to stay constant over the next five years. However, the redevelopment work will attract a further depreciation charge of 2% per year on cost. Each stage of redevelopment will be depreciated separately, commencing in the year following its completion. The club has large accumulated losses for taxation purposes and no tax liability is likely to be incurred over the next five years.

Chris argued that all the funding for the takeover should be in the form of equity and that no dividends should be paid throughout the period of the proposed investment. He felt that, following the period of financial crisis, it was important in retaining the goodwill of supporters and other stakeholders to rid the club of debt. He also argued that the company should be de-listed from the London Stock Exchange as soon as the takeover was completed. He argued that this would allow the consortium greater freedom of action. Members of the consortium would take over executive directorships to drive through the changes required and to protect their investment. To 'sweeten' the takeover deal, however, the chief executive of the club, who exercises considerable influence over existing board members, would be offered the role of non-executive chairman of the reconstituted board. Chris would then take over the role of chief executive.

Before the meeting ended Chris was questioned closely about three key issues. Firstly, consortium members were keen to know when Premier League status was likely to be regained. Chris had already consulted with Brian Framlington on this matter, who believed that it would most likely be regained at the end of the 2008/9 season. By this time, the new players should be in place and playing as part of a disciplined team. Brian believed it was possible, however, that promotion could be achieved one season earlier providing key players could adapt quickly to the style of play required. In his view, the worst possible scenario was that promotion would occur at the end of the 2009/10 season.

The second issue that exercised the minds of consortium members was the outstanding loan. Although the bank had been considerate over the breach of covenants and had not put the club under real pressure, Chris repeated his case for ridding the club of debt and argued that early repayment should be agreed and funded by the consortium during the 2006/7 season. The interest on the loan for the period up to the redemption date was expected to be £2·1m.

The final issue concerned the exit strategy that Chris Ambridge had in mind. Chris argued that, after five years, the team should be enjoying success once more and that the development of the stadium would be complete. At this point, the club would be floated on the London Stock Exchange and that a price earnings ratio of 8·0 times could be achieved. The decision to re-float the club took the consortium members by surprise and some wondered whether a London Stock Exchange listing was really appropriate for a football club. Although some clubs, including Barchester Rovers, had obtained a listing in the past, they were a minority and market sentiment had turned against football clubs because of their relatively poor stock market performance.

Despite some reservations over the proposed exit strategy, it was unanimously agreed that the takeover proposal was worthy of further investigation. It was therefore decided that Chris and other representatives of the consortium should meet with the board of directors of Barchester Rovers to discuss a possible price for acquiring the shares. It was also decided to appoint an independent firm of accountants to examine both the proposed acquisition target and the plans proposed by Chris Ambridge and to report on the key problems and risks that the consortium might face.

Members of the consortium have indicated that they would expect a minimum return of 16%.

Required:

(a) Calculate the expected net profit (loss) and incremental cash flows for each year over the proposed five-year investment period, assuming that promotion to the Premier League occurs at the end of the:

(i) 2007/8 season;
(ii) 2008/9 season;
(iii) 2009/10 season. (30 marks)

(b) Calculate the maximum price per share that the consortium should be prepared to pay to acquire all the shares of the club, assuming that promotion back to the Premier League occurs at the end of the:

(i) 2007/8 season;
(ii) 2008/9 season;
(iii) 2009/10 season. (12 marks)

(c) Using the information provided in your answers in (a) and (b) above, and any other information which you consider appropriate, provide an assessment of:

(i) the forecast financial performance of the club over the next five years,
(ii) its likely financing needs over the next five years, and
(iii) a share price for the takeover that is likely to satisfy each side. (15 marks)

(d) Prepare a report which identifies and briefly discusses the information that the independent firm of accountants should gather in order to identify the potential problems and risks associated with both the acquisition target and the proposals outlined by Chris Ambridge. (20 marks)

(e) Outline the risks involved in making the existing chief executive of the club the chairman of the reconstituted board and suggest how these risks should be managed by the new chairman and new chief executive. (8 marks)

(f) Outline the advantages and disadvantages of a football club obtaining a listing on the London Stock Exchange. (10 marks)

(g) Identify other exit strategies that might be available to the consortium if it is ultimately decided not to re-list the club on the London Stock Exchange. (5 marks)

Notes:

In answering the case study questions, the following points must be taken into account:

1. Assume that it is now August 2006, that is, the beginning of the 2006/7 football season.
2. All key workings must be shown and key assumptions must be clearly stated.
3. Calculations in (a) and (b) should be in £ millions and to one decimal place.
4. Inflation should be ignored.

(100 marks)

End of Project