

QUESTION 2

100 marks

Background to Phantasy

Phantasy (Pty) Ltd ('Phantasy') was founded in 2007 by Mr Michael Phillips with the intent of developing, owning and managing a chain of luxury 5 star hotels in South Africa. Having worked for many years in the American hospitality industry, Mr Phillips was determined to put together a group of hotels that would be vastly superior to any other in the country. Accordingly, in January 2008 Phantasy acquired an option from the Phillips Family Trust to purchase a magnificent site on Beach Road in Port Elizabeth on which to construct its first hotel.

After developing a comprehensive business plan, Mr Phillips contacted three private investment advisers who, in return for undisclosed commissions, convinced a number of their wealthy retired clients to invest in Phantasy. These clients subscribed for R45 million in the preference share capital of Phantasy. Mr Phillips himself retained 100% of the ordinary shares in issue, being 100 ordinary shares of R1 each. Simultaneously with the capital raising exercise, Mr Phillips entered into negotiations with a consortium of funders to raise a 20-year unsecured loan for Phantasy of R165 million.

After difficult negotiations, Mr Phillips reached agreement with the consortium on the basis that the loan would bear interest at a fixed rate of 13% per annum and that for the first seven years neither the interest charges nor any capital needed to be repaid. Interest for the first seven years after the advance of the loan would be capitalised annually in arrears. The loan is repayable in 13 equal annual instalments of R63 409 320, commencing on 31 March 2016. As part of the agreement, Mr Phillips granted the consortium an option to acquire 30% of Phantasy's ordinary shares in issue from himself for a consideration of R40 million at any time between 1 April 2008 and 31 March 2015. The loan was advanced on 1 April 2008.

Construction of the hotel

Phantasy acquired the Beach Road property for R16 million in May 2008. Construction of the 85-room hotel and conference centre commenced in June 2008 with an intended opening date of September 2009. Unfortunately, the construction project was delayed on numerous occasions as a result of non-compliance with prevailing environmental legislation, which Mr Phillips had insisted was irrelevant and petty. The hotel finally opened in January 2010 which unfortunately meant that it missed the peak tourist season at the end of 2009.

The eventual construction cost of the hotel amounted to R152 million, which included capitalised interest. On viewing the hotel and its facilities, industry experts were unanimous in their praise for what Phantasy had achieved, stating that the company had built one of the finest hotels in recent history.

While Phantasy was busy constructing the hotel, Mr Phillips convinced an old friend of his, Mr Reginald Dwight, to become the general manager of the hotel. Mr Dwight immediately started recruiting and training staff and putting in place systems and controls. All staff recruitment and training was done by Mr Dwight's son, who charged commercial rates for his services.

All the furniture, fittings and equipment needed for the hotel were imported by Mr Saul Hudson, Mr Dwight's brother-in-law, who specialises in the sourcing of exotic furnishings. Although somewhat shocked at the cost of these furnishings, Mr Phillips accepted the quote from Mr Hudson after he and Mr Dwight spent a delightful week with Mr Hudson on the latter's private island off the coast of Mozambique.

Trading history

Since the opening of the hotel, occupancy and daily room rates achieved have been well below what was envisaged in the initial business plan, partly because a number of new luxury hotels opened in Port Elizabeth in the run up to the 2010 FIFA Soccer World Cup. Subsequent to the Soccer World Cup, the position further worsened as the number of visitors to Port Elizabeth fell dramatically because of the impact of difficult economic conditions on tourism and business travel.

The period from 2010 to 2013 was very difficult for the hospitality industry in general and for Phantasy in particular. In response to falling occupancy levels, Mr Dwight organised a number of meetings with local hotel owners and attempted to persuade them to resist cutting daily room rates. This strategy did not work, and most hotels in the area did cut their daily room rates in an attempt to boost their occupancy rates. During the course of 2013 three large luxury hotels in Port Elizabeth were placed in liquidation.

Abridged financial information

The following abridged financial information has been extracted from the management accounts of Phantasy for the years ended 30 September 2011, 2012 and 2013:

STATEMENTS OF FINANCIAL POSITION				
AT 30 SEPTEMBER		2013	2012	2011
	Notes	R'000	R'000	R'000
Non-current assets	1	159 667	168 172	176 199
Land		16 000	16 000	16 000
Buildings		140 600	143 640	146 680
Furniture, fittings and equipment		3 067	8 532	13 519
Deferred tax asset		35 759	23 781	12 918
Current assets		72 210	70 539	72 518
Inventories	2	4 340	4 032	3 885
Trade and other receivables		4 121	3 470	3 242
Cash and cash equivalents		63 749	63 037	65 391
Total assets		267 636	262 492	261 635
Ordinary share capital		0	0	0
Preference share capital	3	45 000	45 000	45 000
Accumulated losses		(109 841)	(79 040)	(51 107)
Total equity		(64 841)	(34 040)	(6 107)
Non-current liabilities		326 442	290 520	259 491
Long-term loans		323 762	286 515	253 553
Instalment sale liabilities	4	2 680	4 005	5 938
Current liabilities				
Trade and other payables	5	6 035	6 012	8 251
Total equity and liabilities		267 636	262 492	261 635

STATEMENTS OF COMPREHENSIVE INCOME				
FOR THE YEARS ENDED 30 SEPTEMBER		2013	2012	2011
	Notes	R'000	R'000	R'000
Revenue	6	39 212	35 301	32 054
Cost of sales	7	(27 741)	(25 304)	(23 364)
Salaries and wages		(22 973)	(21 057)	(19 497)
Food and beverage costs		(4 768)	(4 247)	(3 867)
Gross profit		11 471	9 997	8 690
Other hotel expenses	8	(1 455)	(1 528)	(1 200)
Marketing costs		(505)	(678)	(410)
Consumables expenditure		(950)	(850)	(790)
Controllable profit		10 016	8 469	7 490
Utility costs	9	(8 924)	(8 340)	(6 409)
Earnings before interest, taxation, depreciation and amortisation (EBITDA)		1 092	129	1 081
Depreciation		(9 264)	(9 042)	(8 796)
Net interest		(34 607)	(29 883)	(25 684)
Interest received	10	2 881	3 439	4 020
Interest on long-term loan		(37 247)	(32 962)	(29 170)
Instalment sale interest		(241)	(360)	(534)
Loss before taxation		(42 779)	(38 796)	(33 399)
Taxation		11 978	10 863	9 352
Loss for the year		(30 801)	(27 933)	(24 047)

Notes to the abridged financial information

- 1 Non-current assets: Land is not depreciated. The hotel building is depreciated over its estimated useful life of 50 years and furniture, fittings and equipment are depreciated over four years on a straight-line basis.
- 2 Inventories include food and beverages, and consumables such as hotel uniforms, crockery and cutlery, linen and stationery.
- 3 The preference shares are entitled to a coupon of 10% per annum only if and when the company chooses to declare such dividends. Redemption of any or all of the preference shares is at the sole discretion of the company.
- 4 The instalment sale liabilities arose solely at the initial acquisition of furniture, fittings and equipment.
- 5 Trade and other payables include trade creditors and value added tax (VAT).
- 6 Phantasy earns revenue from three primary sources:

	2013	2012	2011
	R'000	R'000	R'000
Segmental revenue			
Room revenue	21 897	19 703	17 163
Food and beverage revenue	13 244	11 798	10 742
Conference revenue	4 071	3 800	4 149
Total revenue	39 212	35 301	32 054

Relevant statistics in respect of room revenue for the periods under review are as follows:

	2013	2012	2011
Average daily room rate	R1 285	R1 295	R1 200
Occupancy levels	56%	50%	47%

Occupancy levels are calculated on rooms being available for 358 days each year.

Food and beverage revenue achieved is consistent with the industry average of approximately 33% of total revenue per hotel.

Conference revenue is derived from renting out conference rooms and facilities to third parties. Conference revenue as a percentage of total revenue varies between 10% and 12% for most regional hotels, although Phantasy's target is 15%.

- 7 Cost of sales comprises all employee costs and the costs of all food and beverages sold. Employee costs are relatively fixed in nature and do not vary with occupancy levels.

Food and beverage costs of Phantasy were 36% of food and beverage revenue, which is consistent with that of other 5 star hotels.

- 8 Other hotel expenses comprise marketing costs for promoting the hotel as well as expenditure on consumables.
- 9 Utility costs comprise rates and taxes, and water and electricity. Phantasy entered into a five-year contract with the Nelson Mandela Bay Metropolitan Municipality to pay a fixed monthly rate for all utility costs, which will escalate by 10% per annum for the next five years irrespective of the actual consumption of water and electricity. The contract became effective on 1 October 2012.
- 10 Interest received arises from the investment of surplus cash resources in money market instruments.

Outlook for the medium term and marketing strategies

The board of directors of Phantasy is of the view that tourism and business travel to the Port Elizabeth region will improve over the next three years and it can reasonably be expected that Phantasy will benefit from increased occupancies and improved average daily room rates.

Mr Phillips, however, is becoming increasingly frustrated with the hotel's performance and wrote the following e-mail to Mr Dwight, in which he suggested some tactical operating changes:

To: Reggie Dwight
From: Michael Phillips
Subject: It's only Rock and Roll

Dude, I am getting worried, we need to get more folks into the hotel. The board says all we need is just a little patience but I think we'll be knocking on heaven's door before we turn this sucker around; time is not on our side. Last night I spent a couple of hours with Jonnie Chifumba and his good friend, Buddy Wiser, and between us we have come up with a number of ideas.

Our job is to turn this hotel into paradise city and my thoughts are now as follows:

- a) We need a new marketing campaign under the banner of 'Let's spend a night together'. Get hold of Maggie May and ask her to draw it up. Also tell her to make a plan with her BEE certificate; the last one wasn't good enough for the compliance auditors.
- b) Frequent guest programme – as part of the new campaign we need a discrete rewards programme whereby rewards will accrue to our guests. But we need to make sure that the booking agents are not aware of this (or else they will pass the rewards to the business entities who do the paying) and we must rather deal directly with each guest. Please ask Maggie to apply her mind to this.
- c) Exercise – a number of our guests are just like wild horses and need exercise. Please look at arranging temporary memberships at the Yellow Brick Road gym. We can make this an optional extra for our guests and we should bill it at cost plus 40%.
- d) Call William Rose and tell him we want him to sing some songs and entertain our guests five nights a week in the Grotto Pub. We can settle his bill with free bed nights and free meal vouchers, which he can sell to his mates and that should make all the tax stuff go away.
- e) Also, business folks keep asking for second invoices for amounts greater than they have spent. Well, if they can't get any satisfaction they will stay somewhere else. Let's give them 'pro forma' invoices – it's not our business what they do with them!
- f) Put WiFi in the rooms – business people need to be connected to mail, Facebook, Twitter, or whatever! The costs, if we restrict usage, will be minimal and therefore we don't need to charge. Please put this in place urgently.
- g) Adult channels in the rooms – where ever I travel overseas you can download pay per view movies just as we offer but you also have the option to select from a range of adult movies. We should offer this but need to make sure that the charge on the bill always reflects this as a room service charge. That way no one is embarrassed and our clients can claim their total expenses in the normal manner.

Remember our competitors have chosen a strategy of live and let die – this doesn't work for me! Rather, the first cut is always the deepest and so we need to strike early. Let's get busy now and we'll be sailing before the November rain.

Yours in search of profit

Michael

PS : Don't worry about the board needing to approve anything, what we are looking to do just makes good business sense and should we take some uphill I'll just replace whomever objects with more 'entrepreneurial' directors!

REQUIRED

		Marks	
		Sub-total	Total
(a)	Critically discuss the financial performance of Phantasy during the 2012 and 2013 financial years. Your answer should include relevant profitability and return on asset ratios. <i>Communication skills – layout and structure; logical argument</i>	28 2	 30
(b)	Prepare a pro forma statement of cash flows for the year ended 30 September 2013 which illustrates how cash was generated and utilised during the financial year.	8	8
(c)	Calculate the occupancy level that Phantasy needed to achieve during the year ended 30 September 2013 in order to break even at the profit before taxation level.	12	12
(d)	Critically discuss the current and future solvency and liquidity of Phantasy. <i>Communications skills – logical argument</i>	12 1	 13
(e)	Identify and motivate at least four viable ways in which Phantasy could improve its solvency and liquidity position during the 2014 financial year and beyond. <i>Communications skills – logical argument</i>	12 1	 13
(f)	Identify, with reasons, any past and/or proposed actions of Mr Phillips, Mr Dwight and Phantasy that may constitute unethical behaviour. <i>Communication skills – clarity of expression; logical argument</i>	22 2	 24
Total			100