

## QUESTION 2

100 marks

In 2001 Johannes Netling and Tshukudu van der Merwe attended a business school programme entitled: *The entrepreneur in you*. Shortly thereafter, and following the advice of a professor who maintained that successful entrepreneurship was only possible if you converted your hobby into your job, Netling and Van der Merwe founded Iron Butterfly Breweries (Pty) Ltd ('IBB'). The company aimed to develop and market draught beer to university students as the two young entrepreneurs reasoned that students consumed more beer per capita than the general population.

IBB faced a number of challenges during its early years, but over time became profitable primarily because its *Hammer of the gods* ('Hog') beer became a student favourite. Although the beer was more expensive than comparative offerings, Hog found favour with university students as it had a higher alcohol content than its direct competitor products and was astutely branded using the catch phrase 'Sooner or later everyone wants to get Hammered'.

Building on the success of Hog, IBB today operates three micro-breweries: one in Cape Town, one in Stellenbosch and a newer and much larger brewery in Lanseria, Johannesburg. IBB produces two alcoholic draught beers, being Hog and Anvil, and one alcohol-free beer, Steel Wheels, which is marketed as the beer of choice for designated drivers. IBB sells its draught beer in 50-litre barrels to select bars and restaurants, located in areas favoured by students, where it is sold in three-litre jugs.

The current board of directors of IBB comprises the following:

- Two independent directors;
- Johannes Netling who, after resigning from IBB in 2009, serves on behalf of the Netling Family Trust (IBB's majority shareholder) and is chairman of the board;
- Tshukudu van der Merwe, who is the chief executive officer (CEO) of IBB; and
- James Malibongwe, who is the IBB finance director (FD).

The board will shortly hold a strategy workshop to review the actual results for the nine months ended 31 March 2014 and the forecast results for the remainder of the financial year. At the workshop, the board will also debate and approve the detailed plans and actions to be followed in the 2015 financial year ('FY2015').

The information and data that follow have been extracted from the board strategy workshop documents:

### **Vision and values**

IBB's vision: *'To be the brewer of choice to South African university students by offering a limited range of high quality, fairly priced draught beers while continually encouraging responsible beer drinking whenever and wherever possible.'*

The values of IBB:

- 1 *Ethics: We aspire to the highest levels of honesty and integrity.*
- 2 *Respect: We treat everyone we deal with in the manner in which we would like to be treated.*
- 3 *Product quality: We do not take short cuts; what we do, we do to the very best of our ability.*
- 4 *Sustainability: We focus on long-term business sustainability even if it means forgoing short-term profit.*

## Financial information

The following are the actual 2013 results and updated 2014 full-year forecast extracted from the financial statements of IBB:

<b>IRON BUTTERFLY BREWERIES (PTY) LTD STATEMENTS OF FINANCIAL POSITION</b>			
	Notes	30 June 2013	30 June 2014
		Actual	Forecast
<b>Non-current assets</b>		29 129 500	28 009 500
Plant and equipment		22 182 000	20 112 000
Land and buildings		6 947 500	7 897 500
<b>Current assets</b>		3 763 000	5 247 000
Inventories	1.1	635 942	1 104 163
Trade and other receivables		2 277 058	2 760 000
Cash and cash equivalents		850 000	1 382 837
<b>Total assets</b>		<b>32 892 500</b>	<b>33 256 500</b>
<b>Total equity</b>		16 747 500	18 591 500
Share capital		100 000	100 000
Retained earnings		16 647 500	18 491 500
<b>Non-current liabilities</b>			
Long-term loans	1.2	9 000 000	8 000 000
<b>Current liabilities</b>		7 145 000	6 665 000
Trade and other payables		645 000	965 000
Short-term portion of long-term loans	1.2	2 000 000	2 200 000
Bank overdraft	1.3	4 500 000	3 500 000
<b>Total shareholders' equity and liabilities</b>		<b>32 892 500</b>	<b>33 256 500</b>

<b>IRON BUTTERFLY BREWERIES (PTY) LTD STATEMENTS OF COMPREHENSIVE INCOME</b>			
	Notes	2013	2014
		Actual	Forecast
Revenue	1.4	34 150 905	31 561 800
Cost of sales	1.5	(16 979 784)	(16 653 789)
Gross profit		17 171 121	14 908 011
Head office costs		(6 299 000)	(5 700 000)
Distribution costs		(3 430 000)	(3 180 000)
Marketing costs		(2 807 835)	(2 794 011)
<b>Profit before financing charges</b>		4 634 286	3 234 000
Net finance costs		(1 684 286)	(1 390 000)
<b>Profit before tax</b>	1.6	2 950 000	1 844 000
Tax	1.7	0	0
<b>Profit after tax</b>		<b>2 950 000</b>	<b>1 844 000</b>

## Notes

### 1.1 Inventories

The forecast build-up in finished goods inventory during 2014 is to be welcomed since the 2013 level of finished goods was well below the desired levels of safety stock IBB needs to hold. The desired level is determined with reference to projected market demand and the four-month shelf life of IBB's products.

### 1.2 Loans

	30 June 2013	30 June 2014
	Actual	Forecast
Rebo Bank	11 000 000	9 000 000
Short-term portion	2 000 000	2 000 000
Long-term portion	9 000 000	7 000 000
Vendor loan		1 200 000
Short-term portion		200 000
Long-term portion		1 000 000

On 1 July 2010 the company borrowed R15 million from Rebo Bank to finance the construction of the Lanseria brewery. The loan capital is repayable in seven annual instalments of R2 million each, which commenced on 30 June 2012, and one final payment of R1 million on 30 June 2019. The loan bears interest at a fixed rate of 9% per annum and interest is repayable annually in arrears.

The vendor loan relates the acquisition of the Grahamstown property and is dealt with below under the heading 'Update on the Grahamstown brewery project'.

### 1.3 Bank overdraft

BXN Bank reduced the company's overdraft facility from R4 500 000 to R3 500 000 with effect from 1 July 2013. The rate that the company is paying is prime plus 3%.

### 1.4 2014 forecast revenue statistics

	Cape Town	Lanseria	Stellenbosch
	Litres	Litres	Litres
Total saleable litres brewed for the year	198 560	1 058 400	207 360
Net addition to finished goods inventories	(7 560)	(22 400)	(4 360)
Forecast sales in litres	191 000	1 036 000	203 000
	R	R	R
Achieved selling price per litre	R23,90	R21,65	R22,50
Total annual revenues	4 564 900	22 429 400	4 567 500

## 1.5 Brewery production performance

The relevant production statistics for each of the breweries for the nine-month period ended March 2014 and the estimates to the 2014 year end are as follows:

### *Cape Town brewery*

This operation has struggled so far in FY2014 with repeated quality non-conformance issues. For the first nine months of the year the brewery operated at 65% of installed capacity (budget 100%) and quality conformance was a disappointing 89% (equivalent to a reject rate of 11% of gross production).

As a result of the production issues the brewery recently replaced one of its fermenting tanks and its beer pump. The costs arising from the replacements have not been capitalised as the carrying value of the existing equipment would require impairment of the equivalent amount at year end. As a result, plant maintenance costs are R470 000 above budget for FY2014.

The production and cost estimates for the fourth quarter of FY2014 are based on the key assumptions that the brewery will operate at 95% of installed capacity and at historic quality conformance rates of 96%.

### *Lanseria and Stellenbosch breweries*

The Lanseria and Stellenbosch breweries have performed as budgeted, with production at 100% of installed capacity and quality conformance in line with historic rates. This performance is forecast to continue in the fourth quarter.

	Notes	Lanseria	Stellenbosch
<b>Forecast production of saleable litres for FY2014</b>			
Gross production in litres for year ended 30 June 2014		1 080 000	216 000
Reject percentage		2%	4%
Total saleable litres produced in 2014		1 058 400	207 360
<b>Cost of production of saleable litres</b>		<b>R</b>	<b>R</b>
Customs and excise	(a)	4 485 880	913 500
Purchases		828 800	162 400
Electricity and gas heating		1 408 900	376 000
Depreciation	(b)	1 433 333	306 667
Water		165 700	32 500
Salaries and wages		1 657 600	424 800
Plant maintenance		414 400	81 200
Barrel maintenance and replacement		950 000	245 600
Total costs		11 344 613	2 542 667
2014 cost per litre brewed		R10,72	R12,26

### Notes

- (a) Customs and excise costs are determined with reference to revenues.  
 (b) Plant and equipment is written off over its expected life of 15 years while buildings are written off over 20 years.

## 1.6 Profit before tax

Total depreciation charged for the year amounted to R2 320 000.

## 1.7 Tax

The company will only become liable for income tax in FY2015.

### Update on the Grahamstown brewery project

As debated and approved in the last board meeting, the company will erect and commission a new brewery in Grahamstown to service the Rhodes University student population. The Grahamstown brewery is on schedule to open in September 2014.

The latest estimate of costs is as follows:

Grahamstown brewery costs	Notes	Budget as approved	Committed to date and latest forecast
		ZAR	ZAR
Land and buildings	1	2 500 000	2 850 000
Brewery	2	Euro	Euro
Brewhouse equipment		192 000	192 000
Fermenting and storage		169 000	169 000
Installation and start up		33 000	33 000
Extras not budgeted for	3		
Gas heating		Nil	19 000
Automatic barrel cleaning		Nil	23 500

### Notes

- 1 The land was acquired for R1 200 000, which is R300 000 more than the approved capital budget, on 31 January 2014. As discussed in the last board meeting, the company, using the services of a local attorney, had entered into an agreement to acquire the land at a value of R900 000 in November 2013. However, once Ms Ruby Tuesday, the vendor, became aware that IBB was contractually committed to buying the brewery plant and equipment, she reneged on the agreement and insisted on a higher value. The company had no option but to pay the additional amount as there were no alternative sites available.

Ms Tuesday has agreed to finance the property acquisition for IBB on exactly the same terms and conditions as Rebo Bank had offered (a six-year loan with interest payable annually in arrears), and which the board approved in the last board meeting, but with the additional benefit that IBB was granted early occupation of the property. The FD signed the loan agreement with the vendor on behalf of IBB.

The company is still awaiting final approval of the environmental impact assessment, but it has been verbally informed that this is a formality and therefore, in accordance with the defined project timelines, construction work has commenced on site.

- 2 The plant and equipment has been ordered from Flexible Breweries ('Flexible') in Austria. The approved capital budget was based on supply of the plant and equipment

by IBB's regular supplier but the project management team later determined that Flexible would provide an equivalent plant but with fully automated controls, for the same price. Therefore the order was placed with Flexible. The fully automated system is expected to arrive on site in July 2014, after which installation will commence.

- 3 Subsequent to board approval of the capital budget, the project management team took a decision to add two supplier options to the facility and these have been ordered. The gas heating option provides an alternative should there be challenges with the electricity supply and the barrel cleaning system will improve operating efficiencies.

The board is requested to retrospectively approve the numerous variations from the approved Grahamstown brewery project.

### **Export sales opportunity**

The company is considering entering into a contract with the African Rain chain of backpacker lodges located in Botswana, in terms of which IBB will supply these lodges, who will stock only IBB products. In turn, IBB will agree not to supply beer to any of African Rain's competitors in Botswana. The contract duration will be 18 months, commencing on 1 July 2014. The agreed prices, which will be denominated in US\$, are to be fixed for the duration of the contract. Payment terms will be 30 days from statement date. It is estimated that this contract will yield a net profit before tax margin of 14% at current exchange rates and using current production costs.

In return for IBB agreeing to the fixed selling price, African Rain will commit to a minimum monthly spend of US\$70 000.

If the company enters into the African Rain contract, some of the beer will be brewed at Lanseria and as there is insufficient capacity to meet the needs of the existing market and the quantity destined for Botswana, IBB proposes to address the capacity shortfall as follows:

- Reduce the brewing time at the Lanseria plant from 30 days to 25 days. It is expected that this will have an impact on the quality of the beer produced and therefore it will be necessary to lower the quality standards, and
- Sub-contract a portion of the brewing of the African Rain contract requirements to Iconic Breweries, which has indicated that it is able to produce whatever quantity is required at the appropriate quality levels.

The board is requested to authorise the CEO to enter into the contract with African Rain.

### **Cape Town marketing promotions**

In FY2014 the sale of IBB's products in the Cape Town area has fallen as a result of product non-availability arising from production issues. IBB's main competitor, Red Rhino Beer, has made huge inroads into IBB's market.

It is clear that if IBB does not respond to the threat from Red Rhino then, somewhat paradoxically, a rhino (albeit a Red Rhino) may be accountable for the extinction of IBB! To address the competitive threat and to reverse the decline in sales, IBB has commissioned T21 Marketing (Pty) Ltd ('T21') to develop a short-term marketing strategy.

T21 has suggested two initiatives to stimulate sales volumes in FY2015 and regain market share:

- That IBB challenge its followers on Facebook to post videos of themselves drinking a jug of its beer. Each week the person whose video is most watched, will receive R500.
- That IBB not increase its sales prices charged to bars and restaurants in Cape Town for FY2015 as the company is already achieving a premium in this market and Red Rhino beer is currently priced at 10% below the IBB offerings.

#### **Proposed dividend**

The Nettling Family Trust, being the largest shareholder in IBB, has requested the board to consider recommending to shareholders that IBB pay a 2014 year-end dividend of R2 million.

REQUIRED		Marks	
		Sub-total	Total
(a)	Prepare a pro forma cash flow statement for FY2014 for IBB.	6	6
(b)	Analyse, compare and comment on the FY2014 forecast production performance of the Lanseria and Stellenbosch breweries. Perform relevant calculations and calculate relevant ratios.  <i>Communication skills – clarity of expression</i>	24  1	  25
(c)	Critically discuss the governance and control issues that have arisen with regard to the Grahamstown brewery project.  <i>Communication skills – logical argument</i>	14  1	  15
(d)	Identify the key risks of entering into the African Rain contract and suggest possible ways in which each risk could be mitigated.  <i>Communication skills – appropriate style; layout and structure</i>	23  2	  25
(e)	Critically discuss the proposed Cape Town marketing promotions and conclude whether or not you believe IBB should follow the suggestions of its consultants.  <i>Communication skills – logical argument; clarity of expression</i>	14  2	  16
(f)	Discuss the key considerations that the board needs to evaluate in deciding whether to recommend that the dividend of R2 million be declared and paid.	13	13
<b>Total</b>			<b>100</b>