MAC3702

APPLICATION OF FINANCIAL MANAGEMENT TECHNIQUES

ASSIGNMENT 02 FOR THE FIRST SEMESTER

DUE DATE: 09/04/2018

UNIQUE NUMBER: 737848

YOU MUST COMPLETE THIS ASSIGNMENT IF YOU ARE REGISTERED FOR THE FIRST SEMESTER.

The assignment consists of **two questions** and counts **100 marks** in total. Each question must be considered independently, except where specific reference is made to information in another question.

Please note that as stated in Tutorial letter 101,page 11, it is practice in our Department to only mark selected sections of this assignment. The sections to be marked will not be communicated beforehand so it is imperative that you answer the whole assignment.

No multiple-choice questions (MCQs) will be asked in the examination; therefore you must prepare yourselves to answer scenario type of questions for all the topics in this module.

This assignment is a written assignment and can either be written or typed, converted to a **PDF** document and submitted online on myUnisa.

DO NOT upload assignments as ***read only*** or **password-protected** PDF document.

Assignments may not be submitted by POST, FAX or E-MAIL.

QUESTION 1 **50 marks**

Ubuntu Group SA Limited (UGSA) is a food retail group based in South Africa and listed on the Johannesburg Stock Exchange (JSE). The group's operations comprise of a chain of retail grocery stores and three manufacturing facilities in South Africa. UGSA manufactures an extensive range of consumers products. These products are distributed through multiple channels, including the groups' own grocery stores.

UGSA was first listed on the JSE in 1980. In recent years, UGSA adopted the following vision statement:*To be recognized as the leading brand of choice in grocery products in South Africa.* In pursuit of this vision, the company intends pursuing organic growth opportunities as well as acquisitions in selected markets.

The most recent financial results for UGSA are summarised below:

Consolidated Statements of Financial Position at 31 December 2017:

	2017	**2016**
	R'000	**R'000**
Non-current assets	**2 531 600**	**2 086 756**
Property, plant and equipment	1 638 353	1 204 637
Other financial assets	146 739	147 221
Intangible assets	746 508	734 898
Current assets	**2 157 526**	**2 508 769**
Inventories	1 003 973	922 689
Trade and other receivables	636 201	588 002
Cash and cash equivalents	517 352	998 078
TOTAL ASSETS	**4 689 126**	**4 595 525**
Total shareholders' equity	**3 178 235**	**2 611 965**
Share capital and share premium (10 000 000 shares)	750 000	750 000
Retained income	2 428 235	1 861 965
Non-current liabilities	**288 412**	**625 696**
Long-term borrowings	181 406	521 117
Deferred tax	107 006	104 579
Current liabilities	**1 222 479**	**1 357 864**
Trade and other payables	882 768	1 046 780
Short-term portion of long term borrowings	339 711	311 084
TOTAL EQUITY AND LIABILITIES	**4 689 126**	**4 595 525**

Extract of the Consolidated Statement of Comprehensive Income for the years ended 31 December 2017:

	2017	2016
	R'000	**R'000**
Revenue	4 829 211	4 676 246
Cost of sales	(2 630 426)	(2 398 836)
Gross profit	**2 198 785**	**2 277 410**
Selling and distribution expenses	(585 075)	(526 506)
Marketing expenses	(219 057)	(202 331)
Fixed and administrative expenses	(371 630)	(277 245)
Research and development costs	(70 680)	(59 259)
Operating profit	**952 343**	**1 212 069**
Finance income	19 197	24 968
Finance costs	(68 052)	(94 268)
Dividend income	28 215	32 265
Profit before tax	**931 703**	**1 175 034**
Income tax expense	(176 679)	(342 435)
PROFIT FOR THE YEAR	**755 024**	**832 599**

Additional information relating to Ubuntu Group SA:

1. 80% of UGSA total revenue (in terms of value) is derived from credit sales.

2. The company's official credit policy states:
   - Credit limits are set for each debtor based on the debtor's credit rating. Sales to debtors may not exceed their credit limits; and
   - Total exposure to a single debtor may not exceed 4% of the total outstanding receivables balance.

3. During the 2017 financial year (ended December), one of UGSA's debtors was liquidated. UGSA received 30c for every 1 rand from the liquidators, and the balance of R1,8 million was written off. The debtor had a limit of R2 million.

4. Operating profit includes:

	2017	2016
	R'000	**R'000**
Bad debt	62 144	71 970

5. In terms of a recent Broad-Based Black Economic Empowerment verification, the group was rated as a Level 5 Contributor which is low compared to its peers.

6. A dividend of 226 cents per share (2017) and 249 cents per share (2016) was declared in the respective financial years. In terms of the group's dividend policy, a constant dividend payout ratio is maintained.

7. The current South African tax rate is 28%.

8. The prime lending rate is currently 8,5%.

9. There are 365 days in a year.

Industry background information

A central driver of this industry is the high cost of discovering, researching and developing food products. To protect their investments, the food development companies apply for patent-protection of their products. These patents then afford an exclusive right to its holder, but normally only last a maximum of 20 years from the date of filing.

In the coming years, a large number of patents will expire. This loss of patent protection is likely to affect future food-pricing and is expected to create a high demand for non-original similar products.

In South Africa there is strong competition between grocery stores, with dominant retail chain stores controlling a large share of the market.

The food industry in South Africa is highly regulated and legislated. Legislation, such as the Consumer Protection Act regulate the marketing, distribution and packaging of food products.

Industry ratios

The following ratios, percentages and calculations represent averages for the South African food industry:

	2017	**2016**
Credit losses as a % of credit sales	2,5%	2,3%
Receivable collection days	53 days	50 days
Debt to equity ratio (based on fair market values)	20,6%	30,8%
Interest cover	8,7 times	8,5 times

New product development

UGSA has its own research and development facility. They are at the forefront of organic and healthy finger foods for toddlers and babies. A new product range was recently appraised using the NPV method. The calculations performed indicate that the product will create value for UGSA and consequently the board of directors approved production.

The new product range requires a new manufacturing machine worth R9 000 000. The directors of UGSA are now faced with the decision of how to finance the machine. UGSA currently has very low levels of debt and they would therefore like to use debt finance. The following alternatives have been identified:

- a R9 000 000 bank loan with interest and capital repayable in one bullet payment in five years' time at a fixed interest rate equal to prime plus 2%.
- Alternatively, the machinery could be leased in terms of a finance lease for five years at R2 800 000 per annum, payable annually in advance.

Maintenance and servicing will cost R750 000 per annum if the machine is purchased outright. The lease charge includes maintenance and servicing.

SARS will most likely allow the new machine to be written off in terms of section 12C of the Income Tax Act (40% in year one and 20% in the remaining three years).

Unless otherwise indicated, it is reasonable to assume that all cash flows during a year occur at the end of the year.

REQUIRED		
(a)	**Identify** the key risk facing UGSA and indicate ways in which these risks could be mitigated with reference to the food industry and South African context. *Communication – logic and layout*	(12) *(1)*
(b)	**Calculate** the following ratios for 2016 and 2017: i. bad debt percentage ratio ii. receivables collection period iii. dividend pay-out ratio iv. P/E multiple **Discuss** UGSA's current credit policy ito ratios (i) and (ii) and also comment on UGSA's sales and credit limits. (Round to one decimal)	(18)
(c)	**Calculate** the amount UGSA received from the debtor upon liquidation.	(3)
(d)	**Discuss** three benefits and three limitations of UGSA's dividend policy.	(6)
(e)	Determine which source of finance for the machine is cheaper by **calculating** the internal rates of return (IRR).	(10)

(50)

QUESTION 2 **50 marks**

Fresh Veg Limited specialises in the growing of organic vegetables and has been in existence for 3 years. They supply local restaurants with fresh produce on a daily basis but has to expand in order to take their business to the next level. Their aim is to become the organic vegetable supplier of choice and therefore they are considering a project to expand the business in order to supply fresh produce on a larger scale.

The company was established by Thomas Mashaba and his wife, Stephanie. The current shareholding is as follows:

	Shareholding %
Thomas Mashaba	25%
Stephanie Mashaba	20%
Scello Tau	5%
Organics Limited	35%
Various shareholders with a maximum shareholding of 1,5% each.	15%

The project entails the purchase of a farm and the construction of tunnels to plant the vegetables in. The aim of the expansion programme is to supply organic vegetables to the larger retail market. The total value of the capital investment for the project is set at R15 million.

Fresh Veg Limited currently has no surplus funds to finance the project.

The current capital structure at 28 February 2018 is as follows:

	R
Ordinary share capital	15 500 000
Retained income	3 250 000
Total ordinary shareholders interest	**18 750 000**
Long-term loan	4 687 500
Total capital employed in the company	**23 437 500**

At the end of the project, Fresh Veg Limited wants to achieve a debt:equity ratio of 40:60 for the entire company.

Fresh Veg Limited contracted the services of a business consultant, and received the following two proposals:

Proposal one:

Ordinary shares

- Issue ordinary shares at a price of R5,50 per share. The issuance cost will be 3,5% of the share price.
- Fresh Veg Limited estimates that the current growth rate of 5% in earnings will double with the expansion.
- The current earnings per share amounts to R2,50.
- The company maintains a constant dividend cover ratio of 4 times.

Preference shares

- Issue 12% redeemable preference shares at a nominal value of R120. The issuance cost will be R2,50 per share.
- The 12% is considered reasonable in the market.
- The preference shares are to be redeemable as follows:
- Each preference share will be redeemed in 5 years' time in exchange for:
    - ✓ R60 cash and 10 ordinary shares.
    - ✓ The value placed on an ordinary share at the time of the redemption is R6,50 each.

Proposal two:

Ordinary shares

- Issue ordinary shares under the same conditions as in Proposal one.

Debentures

- Issue 14% redeemable debentures at a nominal value of R120.
- The current market related rate is 13%.
- The debentures will be redeemed in six (6) years at a premium of 10%.
- Debentures will always be issued at 14%, irrespective of the prevailing market rate.
- The debenture holders will have the option to receive the cash or to roll the debenture on redemption date. It is anticipated that the debenture holders will choose to roll the debenture.

Thomas Mashaba has been wondering whether it might not be easier to just finance the entire project with a mortgage bond.

The interest rate on the long-term loan is 15% before tax.

The current South African tax rate is 28%.

REQUIRED (NOTE: Round off to two decimals throughout.)		
(a)	**Calculate** how many debentures and ordinary shares need to be issued in terms of proposal two.	(12)
(b)	**Advise** Fresh Veg Limited on which proposal will be the most feasible financing option for the new project, taking into account the **required capital structure after** the new financing, and considering the maximisation of the value of the company as being the only aim. Support your answer with the necessary calculations.	(16)
(c)	**Advise** Fresh Veg Limited on the impact both proposals will have, taking into account the effect it will have on the company's risk, return and control. Differentiate between preference shares and debentures.	(10)
(d)	**Advise** Thomas Mashaba on the feasibility of his idea that a mortgage bond should finance the entire project. Discuss the impact that taking out a mortgage bond will have on the risk, return and control of the company.	(10)
(e)	**Explain** the concepts of positive and negative gearing.	(2)

Presentation and Layout *(2)*

Available marks *(52)*

Maximum marks (50)

TOTAL [100]