Ans.1 SGC Construction

(a) The market environment

The competitors that are described in Appendix 3 are either more diversified than SGC in terms of activities, or they operate in more than one geographical market, or both. As a specialist in recent years in government infrastructure contracts, SGC may have faced less competition in this sector than if it were targeting the whole construction market, but the strategy of PDY described in Exhibit 4 may begin to threaten its position. SGC's dependence on government contracts, with two-thirds of its annual revenue coming from government infrastructure projects, could become a threat to future growth if competitors with better cost control and more competitive tender bids become more active in the market.

As well as being threatened by competitor activity, SGC's operations will be affected by government policy in Pakistan. Future infrastructure and construction projects might be restricted by local economic conditions and planning policies.

There is an ongoing threat to the construction market from any sustained economic downturn, with low overall confidence leading to falling investment. Pressure on government revenues (such as reduced tax receipts from falling employment, which also affects consumer purchasing power) may lead to delays in government investment, or the cancellation of future planned projects. In such an environment clients are more resistant to price increases, and where projects are undertaken they are likely to move to lower priced competitors.

The condition of the global economy impacts the construction and engineering industry, with interest rates affecting the demand for projects, as well as SGC's financing costs. Rates of inflation affect the cost of construction projects and their long-term returns, creating uncertainty when bidding for new work.

Another important factor for SGC is the behaviour of interest rates, with its large borrowings. Any increase in interest rates will add to its finance costs, and reduce profitability. The fact that finance costs in 20X7 are nearly the same as in 20X6, despite total borrowings being over Rs12 million less in 20X7, indicates that interest rates rose, either because of rising market rates, a deteriorating credit rating for SGC, or a combination of both.

Key risks

For companies involved in long-term contracts such as those undertaken by SGC, there can be a time-lag between bidding for a project, committing the costs and then receiving earnings. Project over-runs are a significant risk; these have occurred at SGC during 20X7 and can present a significant risk to cash flows and project profitability. Delays in completing projects could deter clients from working with SGC in the future, which could be a large problem when SGC is so dependent on the government as its major client.

In 20X7 there was a net cash outflow of almost Rs17 million relating to finance flows. If SGC were to miss any of its interest payments or capital repayments this could lead to the bank demanding repayment, and/or serious difficulties in obtaining finance in the future.

In addition to the direct effect upon SGC's profitability, interest rate rises can also have the effect of reducing demand for construction activity, as SGC clients might not be able to afford to undertake large projects and might put their plans on hold.

Construction projects by their nature are very high risk. They have enormous financial and resourcing requirements. SGC must make sure that it can guarantee a supply of technically qualified people, tools and materials. Proper management of supply chain risk is therefore fundamental to how well SGC performs in the coming months as it seeks to return to profitability.

SGC needs to make sure that it has continued confidence in the systems that it has in place to monitor the work of subcontractors and materials suppliers, and that its procurement procedures are efficient. SGC faces significant risks from any underperformance by suppliers which would jeopardise the completion of projects on time and within budget.

(b) SGC is a company with a long history, and is a well-regarded company with a good reputation. It appears to have been successful at managing change, with the move from small/medium-sized private sector work to larger public sector projects having worked well in recent years. It has a highly trained and experienced workforce, established relationships with subcontractors, and experience in controlling their activities.

However, there appears to have been an over-reliance on government sector projects, which could be dangerous if the government cuts its spending and if competitors such as PDY Ltd become more active in this sector. This already seems to be happening. During 20X7, SGC lost out on some projects to competitors and it also had to accept lower margins on certain contracts.

Although management has long experience, it may not be sufficiently entrepreneurial in the new trading conditions and forecasts of a swift return to profitability may be optimistic – is management too complacent? The composition of the Board is small, and it lacks the independent directors that are needed to challenge the strategic direction that it has taken.

The Board has stated that one reason for the poor financial results is that a number of projects came to an end during 20X7, but the company must have been aware in advance that this would happen. Why was the company unable to win new contracts and fill its order book by replacing the projects that were ending? The government did reschedule some contracts that SGC had hoped to tender for, which is out of SGC's control, but there may be some question over SGC's ability to adequately plan its pipeline of work in advance of projects coming to an end.

Competitors are known to be more diverse in their activities than SGC, and so may be less threatened by downturns in the public construction sector. SGC's revenue declined by 30% during 20X7, and its gross profit margin has fallen from 21.6% to 15%.

The company's overall loss for the financial year 20X7 has contributed to a substantial fall in its holdings of cash and cash equivalents, down from Rs19 million to Rs9.5 million. If the company continues to make losses in 20X8, it may run out of cash and face a liquidity crisis that could result in insolvency. The cash flow position was made worse by a dividend payment of Rs1.5 million, which seems difficult to justify in the current trading conditions, even though it is much reduced from the dividend payment in 20X6.

The suggestion of the CEO to counter the revenue downturn with price rises on new contracts will impact future business. The construction market in Pakistan is very competitive, and higher contract prices are likely to mean that revenues decline even further as tenders are not won. Additionally, the company's major customer is the government, which will be aware of its buying power and therefore likely to resist price rises by accepting tender bids from rival companies.

Delays on two major projects resulted in higher costs during 20X7. The reasons for the delays should be investigated, to establish why the delays and the excess spending occurred. It may be the fault of suppliers, subcontractors or even SGC's own processes. A high level of costs is likely to be common throughout the construction industry, but cost control appears to be an issue that needs addressing by SGC, with its fall in gross margins. PDY Ltd has implemented a rigorous cost control programme that it believes will make it more competitive, and more of a threat to SGC.

SGC should ensure that it has contingency plans in place for when subcontractors or suppliers are unable to perform their obligations, meet standards or otherwise cause project delays in the future. Failure to do this could result in significant unanticipated costs, because if a project is delayed or disrupted, significant resources are tied up and SGC management time consumed.

The private equity firm will want to see a return on its investment, probably within the next three or four years, and so is likely to become actively involved in turning the business around from its loss making position. This could mean SGC losing some control of strategic decisions, the imposition of further cost control initiatives and possible changes in the senior management team.

Action has already been taken to identify where operating costs can be reduced, but this should not be at the expense of SGC's reputation for quality. Its proven ability to deliver on large and complex projects should set the company up for success when economic conditions improve and the Pakistan government invests in large new projects in the future.

(c) The growth expectations of SGC appear to be unrealistic, particularly if they are based upon the CEO's tactic of simply increasing prices to offset the revenue downturn. In the current economic conditions, and with the awarding of contracts based on a tendering process, it is hard to see how more contracts could be won in this way.

We do not know whether the banks will be willing to provide additional finance to support the ambitions of a loss-making business, unless prospects for profits and cash flow are good, or adequate security is available for any new loans. There may be too much risk for lending banks, and if banks do agree to lend to finance expansion, they may demand a very high rate of interest.

Looking at the options identified:

Diversification:

It is not clear how much financing would be needed for an acquisition. Where will SGC obtain any additional financing that it needs? At the end of 20X7, total borrowings were Rs79.5 million, and the balance sheet value of equity was Rs172 million. These figures suggest that the gearing ratio is not excessively high (79.5 / (79.5 + 172) = 31.6%), and in theory the company has the capacity to take on extra debt if it wishes to invest in strategies for growth.

The report appears to suggest that acquiring a firm of architects would be an easy fit with SGC's business, and could help with any expansion plans that it might have, especially if it decides to move back into residential housebuilding. This view may be questioned, given that SGC moved away from residential construction several years ago; it may not be easy to move back into this market, especially with large barriers to entry in the form of capital requirements and the presence of competitors such as PDY and RTP with established housebuilding operations. SGC may no longer have the management expertise in housebuilding that it once had. It is therefore not clear how an acquisition of a firm of architects on the back of a return to housebuilding would be easily achievable. Given the recent poor performance of SGC it is likely to face difficulties in funding a move back to a previously abandoned market and a related acquisition.

For these reasons, a strategy of diversification into architectural consultancy and a return to private sector housebuilding is not recommended at this time.

Product development:

Investment in new techniques and solutions is another high-risk business strategy, given the economic conditions and contraction in SGC's main market. SGC would need a good reason not to be a part of new investment in materials, technologies and practices, particularly if its competitors are investing in order to protect their business reputations, grow their revenues and comply w-ith increasing global awareness and regulation of environmental issues. However, SGC does not have sufficient information at the moment to give serious consideration to a strategy of investing in assets supporting new technologies, and the commercial viability of new types of construction in its current markets.

Any proposed investment should be subject to rigorous financial analysis. A major factor in the deterioration in the cash position in 20X7 was Rs39 million paid for non-current asset purchases. The company may need to impose a temporary ban on new asset purchases for at least the year ending 20X8, in order to limit cash outflows.

With a strong adherence to traditional methods, there is likely to be a certain reluctance to adopt innovative technologies in the industry, particularly from SGC's financiers who may not wish the company to invest in unproven methods. In the current economic conditions, such investment by SGC does not appear to be feasible.

Market development:

The CEO believes that SGC's competitors have been performing better because they are more diverse geographically. This insulates them to some extent from local market downturns. However, revenue growth via expanding operations overseas through the acquisition of BKM does carry some risks for SGC.

While trading conditions remain weak, market development in such circumstances is a risky strategy to pursue. With the SGC management not having any experience of overseas markets, there would be a high level of dependence on the existing BKM team in managing the Malaysian operations, with implications for control and potential difficulties if there are any problems with integration of the two businesses. There may be high costs associated with developing this new market, and high exit costs if there was a need to withdraw.

Risks of expansion in Malaysia via -the BKM acquisition would also include foreign currency translation, as revenues would occur in overseas currency. This is, however, naturally hedged at least partially by the fact that costs would also partly be incurred in the same currency. Along with foreign exchange risk associated with foreign currency payments or receipts, there is potential for 'remittance risk', as some countries will not allow money to be freely moved into or out of the country.

Market penetration:

Strengthening existing links with the Pakistan government and other existing customers via successful tendering for new projects represents a strategy of market penetration. This is likely to be the most viable strategy for SGC at the present time. However, it would seem important to obtain more information about the company's current success rate in winning new construction contracts from the government.

SGC usually participates in a tendering process for new contracts, so a full understanding of its costs is also very important, particularly as gross margins have fallen over the past year. SGC must make well-informed decisions on which projects to tender for, and the prices that are to be charged, and this should lead to improved profitability. It should be noted that market penetration may involve the lowering of prices, which contradicts the CEO's wish to increase them, so this conflict will need to be resolved.

Nevertheless, in SGC's current market climate a strategy of market penetration would appear to be the best option for the company. If SGC can strengthen its reputation as a company that is able to deliver quality projects, this should contribute to achievement of its growth targets over the long term.

By contrast, expansion into new markets, investment in new technologies and diversification into new activities all appear to be risky strategies, given the trading conditions and SGC's cash flow position.

(d) Under the Income Tax Ordinance 2001 (ITO 2001), BKM is the resident taxpayer for the purpose of income tax liability as it is a locally registered company in Pakistan. Being the resident taxpayer, the following tax provisions apply on BKM:

1. The receipt of payments (revenues) is considered as 'execution of contract' within the meaning of section 153 of ITO 2001.

2. BKM is taxed on its worldwide income. Business income of BKM is Pakistan source income to the extent to which income is derived from any business carried on in Pakistan. All income derived from Malaysia for building shopping centres is considered foreign source income.

3. In the case of Pakistan source income, the tax withheld @ 7% under this section is considered as final tax. If BKM is a listed company, then tax withheld @ 7% is adjustable against its final tax liability.

4. In case of foreign source income, BKM enjoys the reduction in tax rate. According to clause 3(a) of Part II of 2nd Schedule of ITO-2001, the tax in respect of income from construction contracts executed outside Pakistan is charged at the rate 50% of the specified rates if income from contracts are brought into Pakistan in foreign exchange through the normal banking channel. Furthermore, BKM is also entitled to avail foreign tax credit equal to the lesser of the following, if it has paid tax in Malaysia:

   a. Foreign income tax paid
   b. Pakistan tax payable in respect of the income

Tax implications of acquisition on SGC

It appears that SGC is currently a standalone company without any subsidiaries. The acquisition of BKM is likely to result in a group with SGC as a holding company. SGC may opt to be taxed as one fiscal unit, subject to meeting the specified conditions.

If SGC opts for group taxation under section 59AA, SGC will be exempt from tax under clause 103(a) of Part I of 2nd Schedule if BKM pays any dividend. However, setting off of losses will not be available to SGC as it falls under final tax regime and consequently attracts the restriction imposed by section 169 of the ITO-2001.

(e) There are three possible valuation bases which SGC may use to value the BKM brand:

The market basis – This uses market price and other market transactions. Given that the nature of a brand is unique and intangible, this would be difficult to apply.

The income basis – This would consider the present value of the incremental income generated by the brand. Based on the information provided for BKM, this gives a value of:

	Rs'000
Contribution (Rs33.44m* × 15%)	5,016
Advertising costs	(3,200)
Net contribution	1,816

*** Contribution for year per the forecast provided**

PV = Rs1,816,000/0.1 = Rs18.16m (using 10% as the discount rate)

The **cost basis** – this is the current replacement cost of the brand, which is the PV of the estimated advertising expenditure that would be required, being Rs3.2 million per year and with a stated PV of Rs40 million. The basis on which this value was determined would need to be considered, including allowance for risk and how the expenditure could be expected to replace the effect of the BKM brand. With annual advertising expenditure of Rs3.2 million, the implied discount rate to give a PV of Rs40 million is 8%. Further investigation is appropriate regarding this estimate to make sure that it is realistic.

Given these uncertainties, the BKM brand's current use is its highest and best use, indicating a value of at least Rs18.16 million.

Brand management

The current economic climate is challenging for SGC in its local market, and effective branding to distinguish its construction business from that of its competitors is very important if it is to manage to achieve growth and new business opportunities in Pakistan via the acquisition of BKM.

However, the BKM brand is less well known in Pakistan, and if it was to be used by SGC in a move into building shopping centres, then a local brand management strategy would be required.

The first requirement would be to establish a brand identity for BKM that will appeal to SGC's target market in retail construction. SGC's current success in infrastructure construction is built on its relationships with its clients, materials suppliers, employees, architects and subcontractors. The brand needs to reflect the image that new clients in retail construction will want to buy: key features are likely to be contract price and product and service quality, along with reliability and on-time and on-budget contract performance.

In creating a brand image, SGC must be able to deliver the service and product that its new BKM brand will promise to clients. New brand initiatives are unlikely to succeed without substantial investment in advertising. Some reference should be able to be made to the success of the BKM brand in Malaysia. BKM has spent significant amounts in recent years on B2B advertising, and SGC might consider applying BKM's existing advertising strategy to promote the brand and create awareness and recognition. Strategies may be able to be copied in Pakistan if they translate well to the Pakistan market and the messages are suitable for standardisation. BKM has a strong management team – its own brand marketing expertise could be a useful source of experience and ideas for SGC.

The company should also take measures to protect the BKM name, through legal protection (trademark protection), to prevent rival businesses using the same name or logo in Pakistan.

Ans.2 TTA Airlines

(a) **Seating configuration – revenue generation**

15 first class (FC), 90 business class (BC) and 240 premium economy (PE):

First class	= (15 × 7 days × Rs300k) = Rs31,500k
Business class	= (90 × 3 days × Rs150k) + (80 × 2 days × Rs150k) + (70 × 2 days × Rs150k) = Rs85,500k
Premium economy	= (240 × 3 days × Rs80k) + (210 × 2 days × Rs80k) + (200 × 1 day × Rs80k) + (220 × 1 day × Rs80k) = Rs124,800k
Revenue per week	= **Rs241,800k**

20 first class (FC), 70 business class (BC) and 250 premium economy (PE):

First class	= (15 × 5 days × Rs300k) + (20 × 2 days × Rs300k) = Rs34,500k
Business class	= (70 × 7 days × Rs150k) = Rs73,500k
Premium economy	= (240 × 3 days × Rs80k) + (210 × 2 days × Rs80k) + (200 × 1 day × Rs80k) + (220 × 1 day × Rs80k) = Rs124,800k
Revenue per week	= **Rs232,800k**

Over a whole year, the first configuration would generate Rs469,286k (Rs9,000 × 365/7) additional revenue.

The reliability of these revenue figures depends upon the demand forecasts that have been used. No information has been given on how the market research was conducted, or where – was it conducted just in Pakistan, or were Australian and other international travellers also asked for their views?

It may be possible to increase demand for both first class and premium economy seats under the second configuration, perhaps with targeted marketing promotions to each group, so as to increase demand. However, any cost of such promotion would need to be offset against the potential revenue gains.

There could be a bigger problem with the second configuration, however, because business class is always at full capacity, with demand regularly exceeding the available seats. It is possible that business class passengers will avoid TTA if the perception is that TTA does not cater adequately for business class demand. Having experienced some problems with business class services in the past, TTA needs to make sure that business class passengers are satisfied with the TTA service on this new route.

Recommendation

For the reasons above, it is recommended that the configuration of 15 first class, 90 business class and 240 premium economy seats be used, as it generates more revenue per week and has greater flexibility to take on more business class passengers and more closely cater for market demand within this group.

(b) **Financing the new aircraft**

Lease or buy decision

Buying

	Cash flow	DF	PV
Outlay	(Rs5,500m)	1.0	(Rs5,500m)
Residual	Rs2,000m	0.3855	Rs771m
Tax savings (W1)			Rs904.09
NPV			**(Rs3,825m)**

W1: Tax savings

	YEARS 1	2 to 10	10
	Rs'm	Rs'm	Rs'm
Initial depreciation (5,500 × 25%)	1,375.00	–	–
Annual normal depreciation [(5,500 – 1,375) × 10%]	412.50	412.50	–
Gain on disposal	–	–	(2,000.00)
Total tax allowance	1,787.50	412.50	(2,000.00)
Tax savings (30%)	536.25	123.75	(600.00)
Discount factor @ 10%	0.9090	5.2355	0.3855
Present value	487.45	647.89	(231.30)
Total PV of tax savings	**904.09**		

Leasing – no break clause

PV rentals (paid in advance) = Rs700m × (1 + (AF9yrs 10%))
= Rs700m × (1 + 5.759) = (Rs4,731m)
PV of tax savings of lease rentals = Rs.700m × 30% × (AF10yrs 10%)
= Rs210m × (6.1446) = Rs1,290m
NPV (4,731m – 1,290m) = **(Rs3,441m)**

Leasing – break clause

PV rentals = Rs700m × (1 + (AF4yrs 10%))
= Rs700m × (1 + 3.170) = (Rs2,919m)
PV of tax savings of lease rentals = Rs.700m × 30% × (AF5yrs 10%)
= Rs210m × (3.7908) = Rs796m

PV penalty (net of tax of 30%) = Rs1,900m × $0.7/(1.1)^5$
= Rs826m

NPV (2,919 – 796 + 826) = **(Rs2,949m)**

Comparison

The full lease term of 10 years is comparable with the expected useful life of the asset if it is purchased. Over this period using the assumed discount rate of 10%, leasing the aircraft is the lower NPV option, and on this basis should be the option that is chosen.

In both options, TTA would achieve significant tax savings due to admissibility of depreciation and lease rentals over the useful life.

However, the decision should not be taken on the basis of NPV alone. There are a range of other factors that should be taken into account, particularly as the difference in the two NPVs is relatively small and may be sensitive to changes (e.g. in the interest rate or in the tax rate).

Liquidity may be a key consideration. The purchase of aircraft may be possible from available cash reserves (we have no balance sheet information on this) or the total of Rs11,000 million for the two aircraft needs to be financed (for example by bank borrowings). If the company does not have the available cash, and is near debt capacity, then leasing may be the only available choice, notwithstanding the higher NPV associated with this option.

Risk is also a key factor. If demand for the Karachi to Sydney route is not popular, it may be possible to use the aircraft on other routes. If however the aircraft are only really suitable for this route, or if there is a general fall in demand for TTA flights globally, then the costs of grounding the aircraft for substantial periods or disposing of the aircraft needs to be considered.

In this respect, the break clause offers an exit route after five years which gives a lower NPV than both leasing and ownership. However, the penalty cost is substantial. In addition, while the lease break clause is available after five years, anticipated demand is likely to be examined again before that time (in the scenario, it is stated that demand will remain consistent for the next few years only). If such an analysis of demand after, say, three years shows that demand does not justify the leasing of the aircraft, then the lease contract would be regarded as onerous for two years. An 'onerous lease' is one where the cost to fulfil the lease terms are higher than the financial benefit that is received.

Recommendation

There are benefits to both methods. Unless the preliminary market research that has been undertaken has a high degree of certainty regarding strong levels of demand, then the purchase of one aircraft and the leasing of the other with a break clause may give TTA some flexibility if demand is lower than expected.

(c) **Strategy drivers and key performance indicators (KPIs)**

KPIs should be quantifiable measures that can be used by TTA for setting strategic targets and monitoring actual performance by comparing actual with target.

It is assumed that the board has identified appropriate strategy drivers for the business, and the only requirement in this report is to suggest measures of performance that may be appropriate for these drivers as KPIs.

Geographic expansion

This strategy driver refers to geographical expansion of operations, since TTA already operates flights to several parts of the world. Geographical expansion should be planned and targeted at particular countries or regions. However, suitable KPIs might be:

- Growth in annual sales revenue in specific geographical areas (such as Australia)
- A measure for total sales growth in geographical areas where TTA has established new routes within the previous three to five years
- Number of new routes launched

Promoting the TTA brand

Successful promotion of the TTA brand should result in growth in ticket sales as well as growth in the packages described above. This strategy driver therefore overlaps with selling holiday packages. The success of a brand is evident in sales revenue and profit; but the strength of the brand also depends on customer perceptions, which may change over time. Success in selling the TTA brand should also be measured to some extent in terms of customer feedback. Recommendations for KPIs are therefore:

- Percentage annual growth in sales
- Operating profit margin
- A suitable measure of customer response to the TTA name, such as brand awareness, as measured by an annual market research survey or even research into perceptions of TTA's performance on the new route between Karachi and Sydney

Selling holiday packages

The board of directors presumably believes that there is potential for future sales growth with holiday packages where passengers can book a hotel as well as their flight, possibly because such a service provides a higher profit margin. Recommendations for KPIs are therefore:

- Percentage annual growth in sales revenue from these packages
- Average operating profit margin on these packages

Ans.3 Paragon Fitness Ltd

(a) The working capital of PFL is calculated as follows:

	20X5 Rs'm	20X6 Rs'm	20X7 Rs'm
Inventory	1.8	2.1	2.0
Receivables	3.5	3.2	3.4
Cash	8.6	16.0	16.7
Payables	(16.5)	(15.2)	(14.0)
Advance membership income	(9.0)	(9.5)	(10.0)
Working capital	**(11.6)**	**(3.4)**	**(1.9)**

PFL has negative working capital for each of the years under consideration. If we look at the components of working capital we can identify that this is partly the result of large balances of advance membership income (income received where PFL has not yet provided the related service). This is consistent with the fact that monthly memberships are paid for by members in advance.

The negative working capital figure reduced to Rs1.9 million in 20X7, as a result of the company choosing to significantly reduce its capital expenditure which significantly improved its cash balances.

Management of centres

This possible new business venture has a very different cash operating cycle. If the proposal is taken up by PFL, it is important to recognise that this is a very different business model to PFL's current activities.

PFL receives its membership revenues in advance of paying the related operating costs at the fitness centres, and therefore has a negative cash operating cycle as described above. The new proposal would be very different, as the revenue would consist of a management fee which would be payable six monthly in arrears. It is assumed that property related occupancy costs would not be the responsibility of PFL under the arrangement (as can be seen from the statement of profit or loss, these can be significant) but staff related costs would be.

The total staff related costs for PFL are Rs26.5 million for 20X7. This is based on 15 staff per fitness centre together with head office staff. If we assume that there would need to be a proportionate increase in staff as a result of the new arrangement, then an estimate of the annual level of additional staff costs required to manage these six gyms can be established.

Six additional sites would require an additional 15 × 6 = 90 staff. However, the new sites are only half the size, so 45 staff would be required. This would represent additional costs on a pro rata basis 45 staff / 150 staff × Rs26.5m = Rs7.95m.

Given that the management fee will be payable six monthly in arrears, PFL will need to finance an increase in working capital equal to half of Rs7.95 million, which is Rs3.98 million. In reality this figure is likely to be somewhat larger, as it is likely that some proportion of other operating costs will also be incurred. On its own the figure of Rs3.98 million represents 24% of year end cash, and this may be difficult for PFL to finance while also maintaining a sufficient buffer of cash and continuing to pay down the revolving credit facility.

This effect would be mitigated if the terms were altered such that management fees were payable monthly. PFL may be allowed to offer personal training services through the gyms, which would also improve cash flow as fees are received in advance.

Accelerated investment

In order to meet the competitive threat, the COO believes that PFL needs to accelerate its capital expenditure plans. At the 20X7 year end, the company had Rs16.7 million in cash and unused revolving credit facilities of Rs14 million.

Although this might cover the anticipated additional capital expenditure spend, the full amount of Rs30.7 million of available cash cannot be used as the company needs cash as working capital. Current cash resources are therefore not going to be sufficient to meet the cash needs that accelerated investment would necessitate.

Therefore the options are to scale down the level of accelerated level of capex to the point at which it can be met by available resources (which may not be enough to counter the competitive threat), or seek additional sources of finance. The company currently has a low level of gearing (26 / (26 + 74.3) = 26%, and a high level of interest cover (20.2 / 1.1 = 18 x), so raising additional debt may be a viable option.

A simple option that could be considered would be to approach PFL's current bankers and seek a term loan. The amount borrowed could also include the outstanding amount of the revolving credit facility which is due for renegotiation in 20X9.

Another alternative would be to raise additional equity from shareholders/sponsors, which is typically a quicker way of arranging finance and is comparatively less costly than arranging a loan.

Acquisition

The purchase of the Prime Performance Ltd (Prime) fitness centres for Rs45–55 million would represent a very significant transaction. Clearly PFL would be unable to fund this from existing cash resources. Therefore the company would need to raise a significant sum, either by raising debt (such as a loan) or an issue of equity.

Beyond the purchase price of the clubs there are a number of other factors that will have an impact on PFL's cash flow. It is a common mistake for businesses to fail to take into account the additional cash requirements that acquisitions and significant asset purchases cause.

- There will be additional finance to service, either through additional interest or dividends.
- There will also be one-off costs of raising finance. In the case of an equity issue there will be fees paid to advisors. In the case of a loan it is likely that some level of arrangement fee would be payable.
- Therefore it is essential to perform a due diligence exercise on the potential acquisition to uncover any unexpected cash outflows that might be required and also to appraise the budgets and forecasts that have been prepared by Prime's management.
- As PFL would be buying the fitness centres and not the business, there would be a need to refurbish the clubs in order to rebrand them.
- There will be a need to hire staff for the clubs. This is likely to be effected by transferring the employment contracts of existing staff, but there is likely to be a level of costs to achieve this.
- Additional management resource will be required to manage the acquired operations.

- Clearly there will be a need for PFL to meet the ongoing costs related to the acquired clubs, but the business model is likely to be similar to that of PFL, with a negative cash operating cycle. This will, in effect, represent additional funding for PFL from the acquired business.

(b) **Importance of HR in the acquisition process**

The Chairman's concern about the 'people' aspect of the deal appears justified, because a number of the key issues involved in an acquisition relate directly to human resource issues. Although in this case the people-related issues may have a higher profile due to ongoing disputes at Prime Performance, human resources are important in relation to any acquisition. 'People' issues – poor cultural fit, or poor communication – can often be the reason why acquisitions do not prove to be as successful as had been hoped.

The following issues could all be important when trying to integrate Prime with PFL if the acquisition goes ahead.

- **Change process / employee involvement** It is very important to communicate to staff in both companies about the change, their role in the process and addressing any concerns they may have about the acquisition. Staff (particularly at Prime) might even resist the acquisition, and the change and uncertainty associated with being employed by a new company.
- **Dealing with any redundancies** which may be necessary. The issue of redundancies is likely to be particularly sensitive at Prime, given the redundancies which have already been suffered following the introduction of new working methods. PFL will have to give careful consideration to how it handles any future redundancies.
- **Integrating the organisational cultures** of the two companies. At this point, little is known about the culture within Prime, but it is known that it operates at the premium end of the market. PFL has, by contrast, restricted investment in its centres in recent years, so it is unlikely to be a premium brand. If PFL's organisational culture contrasts sharply with that of Prime, then Prime staff could feel threatened, particularly if working methods and expectations of staff in terms of skills and performance are very different between the two companies, or if Prime staff do not want to be associated with lower quality facilities.
- **Retaining key members of staff** and key managers. Although acquisitions often cause staff redundancies, it is also important that key members of staff are retained wherever possible. In this case, it could be particularly important for PFL to retain key centre managers and staff who are known and trusted by members while the transition to PFL branding and operations takes place. This might be difficult, given the likely cultural differences between the companies and their respective offering to members.
- **Aligning the remuneration and reward systems** of the two companies as far as possible. For example, if there are differences between typical salaries and training programmes received by Prime staff and those received by PFL staff for the same job, and the employees become aware of these differences, this could lead to discontent if systems are not aligned to some extent (although there may be limits to how far they can be exactly matched). PFL pays some centre managers well, with a generous bonus scheme and remuneration above the industry average, but there is also a high level of turnover of junior staff and investment in training appears to be lacking.

- **Deciding on HR policies and practice** for the new centres. For example, if Prime and PFL currently have different policies in relation to holidays or reward systems, it seems likely that these will have to be made consistent as far as this is possible.

(c) As ICAP chartered accountants, Faisal and Izad Malik should demonstrate adherence to the ICAP Code of Ethics, and the five fundamental ethical principles that are laid out. The principles of integrity, objectivity, professional competence and due care and professional behaviour are all relevant here.

Integrity

The principle of integrity involves being straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

- Faisal and Kashif Malik are faced with a dilemma: should they be open and honest about the issue, or should they suppress it? They have a responsibility to be straightforward and honest with the information contained in the report. By keeping the report private, they are keeping important information out of the public domain, even though they believe that the report is unfair in its depiction of PFL.
- Izad Malik's behaviour in complying with the decision not to act upon the information has also brought his integrity as a chartered accountant, and that of PFL, into question. He has also told his daughter not to make any public comment on the situation. However, he has subsequently disagreed with Faisal and Kashif, believing that the report should be published, that PFL can legitimately defend itself. He is now conducting his own enquiries into what improvements are required. This represents a more ethical course of action than suppressing the report.

Objectivity

The principle of objectivity means that bias, conflict of interest or undue influence should not be allowed to override professional or business judgment. In addition, relationships that may impair objectivity should be avoided.

- Faisal was allowing bias and a conflict of interest to influence his behaviour when he decided not to close the affected centre, and, along with his brother, to consider covering up the critical report.
- Izad contravened this principle by appointing his daughter as interim manager when she was not qualified for the role. He continued to show a certain level of bias in certain subsequent actions to cover-up the situation (for example by asking his daughter not to make any public comment) but as the situation has developed he has become more concerned about dealing with the situation objectively. He has advocated that the report be published, and launched an investigation of his own, demonstrating a more ethical stance.

Professional competence and due care

The principle of professional competence and due care implies the need to act diligently and in accordance with professional standards.

- Faisal has contravened this principle because he did not take appropriate action on the letter when it was originally received, concerning possible damage to the building. It could be argued that he failed to carry out his duties diligently, or to exercise professional competence, even though there was no firm evidence that there was a safety issue.
- Faisal has an obligation to act diligently on behalf of employees, shareholders, the board, customers and the general public. Faisal and Kashif both have a responsibility to conduct themselves in a manner consistent with the reputation of PFL, and in Faisal's case, the standards expected of a chartered accountant.

Professional behaviour

This is the requirement to comply with laws and regulations, and avoid action that discredits the individual's profession.

- By deciding to keep the report private, Faisal and Kashif could be covering up negligence that has potentially been committed by staff of PFL in failing to act upon information received.
- By contrast, Izad's belief that the report should be published, and that PFL should defend itself openly against allegations of a poor approach to safety, is a more ethical stance to take.
- Management should also seek legal opinion/advice on the case e.g from ICAP. Further voluntarily compensation to the injured members should also be considered.