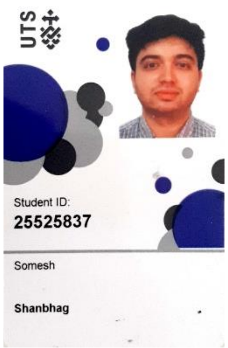
# Assessment 1

UTS
UNIVERSITY OF TECHNOLOGY SYDNEY

25720 - Applied Financial Management

# Footloose Travel Ltd.

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# Table of Contents

# Task 1

From an initial glance, the devastating impact the Covid-19 pandemic has had on this business is very clearly seen. With the help of a horizontal analysis, we can see that net profit began to drop from 2020 onwards and continued this way until a 150% drop in net profit was recorded in 2021 compared to 2020, leading to an ROE of -4.58%. While the company recovered by 138% in 2022, the cumulative net profit was just 12410 AUD, leading to only a 1.28% ROE for the year 2022, which is far lower compared to the market average and with its own performance in previous years which was excellent. While we can attribute this issue to COVID's impact on the travel industry, there was still a fundamental problem in the company’s cash flows long before the COVID pandemic, which, if solved before COVID, would not have caused such a high impact on the company. If we look at the ratio of Days in Receivable, the company takes over 200 days to receive the money for products sold or services rendered. With COVID impacting not just companies but customers as well, it's also possible that many customers might have defaulted on their payments, leading to a considerable impact on the company's operating cash flow. When we compare this against its asset turnover ratio, we see that it can sell its products quickly but does not receive payment until more than 200 days after purchase. This type of credit can either be explained as a poor understanding of cash flow reserves, unhealthy risk appetite or weak credit terms. Due to this delay, the Interest Coverage Ratio clearly shows that EBIT was far below what's required to meet its long-term debt obligations in 2021, suggesting that the company has enough liquidity from its current ratio (primarily due to cash reserves from old high profit margins, which were excellent) to meet its short-term obligations. This may not always be the case in the future, as this type of loose customer payment terms significantly raises the risk of defaulting on its debt. The vertical analysis shows that accounts payable was 72% of its total liabilities in 2021 and increased to 80% in 2022. We see that the company has realized this and attempted to reduce its debt over the years, as explained by its Debt-to-Equity Ratio, which was as high as 1.10 in 2016 which highlights that it had more debt than it could pay off which has now been brought down to more manageable levels of 0.39. However, the delayed inflow of cash is impacting the company's ability to grow as tourism and travelling activities are usually classified as luxury and customer who indulge in travel can generally afford their travel products very easily as it is a tiny part of the overall cost of travelling and lasts through many travels. However, if they have increased the credit period on purpose to make their expensive products more attractive to customers, then they need to recalculate what credit period is more sustainable for the business and what type of customers are eligible to avail of this credit. Overall, it's clear that the company is starting to improve and increase its profit margins. However, it still has a long way to go to reach its pre-COVID levels.

# Task 2

The external funding that is needed based on the base case is $30,288 thousand dollars.

# Task 3

## Question 1

Q. By how much does operating revenue need to change (from 2022 to 2023) before no external funding requirements are expected?

A. In order to need no external funding, a revenue of approximately $ $382,617 thousand dollars would be needed. The operating revenue of 2023 needs to grow by approximately 2% or $ $7,290 thousand dollars when compared with operating revenue for 2022.

## Question 2

Q. Consider a scenario in which international travel grows quicker than expected. In such a scenario assume that operating revenue will bounce back to the 2019 level, but that the accounts receivable item will also increase due to the increase in sales. If the accounts receivable item is also assumed to be 100% of its 2019 value in this scenario, what is Footloose's expected funding requirement for FY2023?

A. $163,459 thousand dollars is the expected funding requirement for FY2023 if the following assumptions are considered and updated into the table.

## Question 3

Q. One option that management is considering is to further cut their fixed operating costs by terminating the lease on various office buildings and to transition to more permanent working-from-home (WFH) arrangements. If this decision is made then the company's fixed costs are expected to decrease to $75 million and their variable costs to increase slightly from 0.5 to 0.6; hence operating expenses = $75 million + 0.6 × operating revenue. How would the funding requirement change from the base-case in this scenario?

A. The external funding required would increase from $30,288 thousand dollars to $40,375 thousand dollars. This is an increase of about 33% or $10087 thousand dollars.

# Task 4

## Question 1

Q. If the funding requirement in the base-case forecast is financed exclusively with additional debt (at 12%), how does this assumption influence the base-case funding requirement? In other words, make the interest expense adjustment to your base-case forecast and report by how much the funding requirement changes.

A. 12% of $30,288 = $3,634.56

The external funding required goes up from $30,288 thousand dollars to $32,833 thousand dollars, which is $2545 or 0.8%.

## Question 2

Q. Do you think that Footloose should plan to raise the required funding by issuing new bonds or by issuing new shares? Please provide arguments to justify your choice.

A. From my understanding of the business, the business should raise this additional funding through debt rather than equity. The reason for this are as follows:-

1) **Low Debt-to-Equity Ratio:** This clearly highlights the currently the amount of debt that the company has is quite low and manageable compared to its past history suggesting that while this is not a risk averse company, they have taken steps to bring down their debt. This means that they have the ability to take on more debt as their shareholders are okay with the risk that the company has been taking in the past.

2) **High Profit Margin**: The company used to maintain a considerably high profit margin which will also allow it to remain cash rich to meet their short-term obligations despite the delayed time between accounts receivables and cash.

3) **Distress Signaling**: If they did use Equity, based on the history and the current state of the company, it would signal to the shareholders that there is something wrong in the company and the stock price for Footloose would drop quite a bit which we currently need to avoid as much as possible due to the already poor performance which prevent the dividend payout over the last two years.

4) **ROE for debt more profitable than ROE for Equity financing**: Currently based on the Analysis while ROIC gives a return of 15.20%, ROE for Debt is giving a higher return at 18.14% as compared to Equity financing that is giving a return of 17.88%. While the difference is less than 1%, the company current ratio is more than 1 which means that more banks will be willing to lend them money as they know that if the worst case

happens they can still get their money back by selling the companies assets. We can see the market improve so the actual risk of taking debt along with an improving market will be lower and hence is a major factor to also consider when comparing against the overall desirability of Equity financing.

5) **Tax Sheid**: With debt financing, the company also offsets its profits leading to lower tax payouts which is a major factor in increasing shareholder wealth and valuation.

# Task 5

## Question 1

Q. Report the values of the IRR, NPV and PI for the O'Riordan investment project. Should Footloose Travel Ltd, accept or reject the proposal? Make a comment on what each of the three financial metrics tells you.

A. The Values for NPV, IRR and PI are as follows:

| | |
|---|---|
| Discount rate = | 11.51% |

| | |
|---|---|
| NPV = | -$5,593,850 |
| PI = | 0.58 |
| IRR = | 4.05% |

NPV is negative, which indicates that the projects expected cash flows, when discounted at the required rate of 11.51% will generate a loss of -$5,593,850. A positive NPV means that the project is likely to add value to the company and is worth pursuing.

IRR is the discount rate at which the NPV of the project is zero. Since the IRR of 4.05% is less than the discount rate of 11.51%, the project is expected to generate returns below the company's required rate of return.

PI measures the return per dollar invested. A PI greater than 1 indicates that the project will generate more value than its cost. However, in this case the PI is less than 1.

Given that the NPV is is negative, the IRR is below the discount rate, and the PI is less than 1, Footloose travels should reject this proposal.

## Question 2

Q. If Footloose was able to depreciate the renovation costs for tax purposes over 10 years, rather than 20 years, would this increase the value of the project (all else being equal)? Explain your answer.

A. No, this further brings down the overall NPV of the project. This is because if the depreciation occurs over lesser period, the overall depreciation is happening at a faster rate which means that keeping aside the tax shield savings that we get from this as a majority of the years we have no tax benefits as our net profit is negative, we also have the lower net operating income and smaller cash flows. This results in lower after-tax cash flows throughout the life of the project. Due to lower Cash flows, NPV is impacted as it uses Free-cash flow to be calculated. PI uses NPV and hence it decreases as well. With respect to IRR, it becomes harder for the inflow of the cash to match the outflow resulting in a lower IRR.

Before:- Depreciation over 20 years

| | |
|---|---|
| Discount rate = | 11.51% |

| | |
|---|---|
| NPV = | -$5,593,850 |
| PI = | 0.58 |
| IRR = | 4.05% |

| | |
|---|---|
| Annual Depreciation | -$150,000 |
| Accumulated Depreciation | $1,500,000 |
| Book Value | $11,700,000 |

After:- Depreciation over 10 years

| | |
|---|---|
| Discount rate = | 11.51% |

| | |
|---|---|
| NPV = | -$5,683,884 |
| PI = | 0.57 |
| IRR = | 3.82% |

| | |
|---|---|
| Annual Depreciation | -$300,000 |
| Accumulated Depreciation | $3,000,000 |
| Book Value | $10,200,000 |

## Question 3

Q. Suppose that Footloose had the option to abandon the project (sell the hotel early) if revenues were not as good as expected. Would this option be valuable to Footloose? What other options might be embedded in The O'Riordan investment?

A. **Option to Abandon**: This is definitely a valuable option that Footloose Travels can choose to follow through on. Based on the IRR of the base case, we can see that the cash outflow is far faster than the Cash Inflow. This means that actually operating the Riordan is where we are making the loss. If we abandoned the project and sell immediately at the end of the third year, we would actually turn a profit.

| | |
|---|---|
| Discount rate = | 11.51% |

| | |
|---|---|
| NPV = | $1,730,547 |
| PI = | 1.13 |
| IRR = | 16.51% |

| | |
|---|---|
| Annual Depreciation | -$150,000 |
| Accumulated Depreciation | $1,500,000 |
| Book Vaue | $11,700,000 |

You can see above that from the calculations if we chose to abandon the project early and sell the O'Riordan, The NPV is positive, the PI is greater than 1 and IRR is 16.63%. which is higher than the discount rate.

This would make the option to abandon very valuable and would turn a decision to reject into a decision to accept the project.

Other options we can evaluate are:

**Option to Expand**: Since we know that the overall operations for the base case are not great and the NPV is negative and the returns are not doing so well, currently this is not a feasible option.

**Options to Delay**: If currently due to labor shortages or resource and supply chains problems, if cost of operations are higher then, Footloose can just wait and invest in the future when these costs are lower. This is another great option that Footloose can consider, if the prospects for investing in O'Riordan currently do not look so good.