Case Study Instructions and Guidance

The case study has two parts to it. The first relates to material covered in **Modules 1 and 2**, and accounts for **65%** of the total mark for the assessment. The second part relates to the material covered in **Module 3** and accounts for **35%** of the total mark.

Part 1 (worth 65%)

In December last year, you became the new CFO of Footloose Travel Ltd, an ASX-listed travel company providing corporate, leisure, and wholesale travel products. The widespread travel restrictions and local and international border closures in response to COVID-19 had a devastating impact on the travel and tourism industry. Footloose managed to survive the shock due to the healthy cash reserves it had going into the crisis and subsequent cost cutting and government support.

While the travel industry has made a strong recovery post pandemic, there is still much uncertainty around the future of the industry and the impact of high inflation and cost-of-living concerns. It is your job as financial manager to assess the company's current financial situation as of the end of FY2022 and to forecast its position into FY2023. This will hopefully ensure that the company has the financial resources it needs to weather the uncertain events of coming years.

Footloose has just released its FY2022 financial reports and a selection of these results can be found (along with the previous 9 years' results) in the Excel data file attached to this case study.

Task 1:
Your first task is to perform a financial ratio analysis for Footloose Travel Ltd over the last 10 years and provide a short summary of the company's financial health as of the end of FY2022, in comparison to the previous 9 years.

> **Guidance on Task 1**: As a minimum you should construct the financial ratios mentioned on page 1.6 of week 2's work, but you do not, and probably should not, mention all of these in your summary. You are also free to use other ratios that you think might provide additional insight. Importantly, the summary should be **no more than a page (500 words)**. You are also free to use graphs if you think it helps. The aim here is use the financial ratios to pinpoint the most important aspects of the company's financial health and performance.

With a solid understanding of the company's past and current financial performance, you now turn to the task of forecasting the company's financial position over the coming year by constructing pro forma financial statements for FY2023. Since COVID-

19 has changed everything, you decide that using data prior to 2022 in your forecast is pointless. Moreover, you do not expect the situation in 2023 to be very different to 2022. You therefore decide to use the percentage-of-sales method for your forecasts and assume that most the 2023 items will be the same percentage of operating revenue as in 2023, with some important exceptions.

Task 2:

Your second task is to construct the FY2023 pro forma financial statements for Footloose Travel Ltd and to forecast the amount of external funding required. The specific assumptions for your base-case forecast should be the ones given below:

- The operating revenue is expected to be a modest 5% higher in 2023;
- The company's operating expenses are not simply a percentage of sales since the company has approximately $100 million of fixed costs to cover each year. To help you, one of your analysts has estimated that operating expense should respond to operating revenue in the following way:

$$\text{Operating expense} = \$100 \text{ million} + 0.5 \times \text{Operating revenue}$$

- Since Footloose is a publicly traded company, and its share price has already taken a substantial battering this year, Footloose's CEO is worried about spooking the market further by announcing a zero dividend again in 2023. Therefore, she has insisted that the dollar dividend amount should be 5% of the forecasted operating revenue in 2023.
- The company's corporate tax rate is 30% which is paid only on profits not losses. In other words, the company will pay zero taxes for the year if they make a net loss. While any taxable loss in FY2023 could potentially be used to offset taxes in future years, this will not affect the company's financial position in FY2023.
- All other items are assumed to be the same percentage of operating revenue as they were in FY2022.

Once your pro forma financial statements are complete, report any external funding that is expected to be required in FY2023 under the above base case.

Guidance on Task 2: To help you construct the pro forma statements for 2023 I have included a column in the Excel file (column L) for the 2023 items. I have also highlighted in green all cells that must be completed in order to arrive at the pro forma statements and the external funding required. Also, do not make any interest expense adjustments for the purposes of this task since we do not know yet how any external funds should be raised.

With your base-case forecast at hand, you now turn your attention to assessing the sensitivity of your forecasts to the assumptions you have made. This will provide you and the management team with some idea about how future scenarios are likely to affect the company's financial position.

Task 3:

Your third task is to use your pro forma spreadsheet to perform a sensitivity, scenario, and simulation analysis. First, answer the following questions:

Question 1: By how much does operating revenue need to change (from 2022 to 2023) before no external funding requirements are expected?

Question 2: 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?

Question 3: 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?

> **Guidance on Task 3**: These questions are standard sensitivity (Q1) and scenario (Q2&3) analyses and should be easy if you have set up your Excel spreadsheet correctly.

Having thoroughly assessed the robustness of your forecasts you turn your attention to how best to raise the external funding required. In other words, the financing choice between debt or equity securities.

Task 4:

Your fourth task is to evaluate whether the funding required under the base-case financial forecast should be raised by issuing new debt or by issuing new equity. You should assume that the interest rate on any issued bonds would be 12% per year due to the increased uncertainty around the travel industry and Footloose's current credit risk profile. Given this, answer the following questions:

Question 1: 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.

Question 2: 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.

> **Guidance on Task 4**: For Q2, you should aim to provide between 250-500 words of analysis. For example, you can discuss the pros and cons of equity and debt financing in this specific context. You may also want to consider the effect of the financing decision on the expected ROE and ROIC under each scenario (relating things back to page 2.8 in week 4).

That's it for Part 1.
Scroll down to go to **Part 2**.

Part 2 (worth 35%)

A couple of weeks have passed, and the company's attention turns toward investments to help improve the company's short-to-medium-term revenue. Australians are rediscovering their own backyard and travelling more within Australia due to the continued covid concerns and the high cost of international travel. Footloose wants to capitalise on this.

Footloose currently own and operate a number of regional hotels and resorts and is considering expanding this line of business by purchasing a number of aging hotels and renovating them. One such investment opportunity is **The O'Riordan**, a hotel located in Orange, NSW, which is in desperate need of an upgrade and is currently on the market for $10,000,000. Footloose's plan is to purchase and fully renovate the aging hotel.

Task 5:

Your fifth task is to evaluate the potential hotel investment and to calculate the various financial metrics that can be used to measure the attractiveness of the project to Footloose Travel Ltd. In order to do this you must first complete the template in the 'The O'Riordan Investment' worksheet in the excel file in order to determine the relevant cash flows. You should use the following information and assumptions to do this:

- Footloose has already spent $150,000 on searching for suitable properties and on architect plans for the renovation;
- It is believed that the hotel can be purchased for its current asking price of $10 million plus an additional $200,000 in legal (and other) fees;
- The purchase will be financed with the company's existing cash reserves;
- The renovation will cost a further $3 million in wages and material (this cost should be added to the project's initial outlay);
- For tax purposes, the cost of the renovations ($3 million) will be depreciated in a straight line over 20 years, however the initial purchase price cannot be depreciated for tax purposes;
- Footloose expects to sell the hotel in 10 years for $16 million (after fees);
- The company will pay tax on any capital gain on the sale of the hotel (any capital gain is calculated as the sale price minus the holding value on the company's balance sheet of the hotel, fees, and renovation costs;
- Once the hotel is up and running, Footloose Travel's operating revenue is expected to be $3 million higher in its first year of operation (year 1), $4 million higher in year 2, and then the revenue is expected to increase by 5% per year (year on year) in years 3-10;
- Footloose's operating expenses are also expected to increase by 45% of the additional revenue generated in each year;
- Finally, to support the running of the hotel, net working capital is expected to initially increase by $300,000 (in year 1) and then be held at 10% of the revenue for each

year of the project. This increase in net working capital is assumed to be fully reversible at the end of the project's life.

Once you have computed the relevant cash flows, you should compute the NPV, IRR, and PI for the project, using the company's weighted average cost of capital (WACC) as the appropriate discount/hurdle rate. To help you estimate the WACC you should use the following additional information:

- The market value of equity is given by the company's total market capitalisation at the end of FY2022 (which is given in row 40 of the company's financial statements);
- To estimate the company's market value of debt, use the book value of debt (i.e., the amount of short-term debt and long-term debt on the 2022 balance sheet);
- For the cost of debt capital, assume that Footloose currently has a fixed rate bond issue with the following characteristics:
  - Contracted coupon rate = 6.25%;
  - Coupon payment frequency = 2 per year;
  - Current market price (as of 20 July 2023) = 92.78;
  - Maturity date = 17 August, 2027.
- For the cost of equity capital, you should use the historical data provided in the Excel file (in the 'Historical Data' worksheet). This gives the weekly share price for Footloose Travel Ltd (FTL) and the weekly index level for the All Ordinaries Index (AORD) for the previous year. In addition you should:
  - use the current yield on 10-year Australian Government bonds as a proxy for the risk-free rate of return; and
  - use a figure of 5.5% for the market risk premium.

Once you have computed the financial metrics you should answer the following:

Question 1: 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.

Question 2: 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.

Question 3: 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?

Guidance on Task 5: Most of the marks for Task 5 will be for determining the relevant cash flows and the computation of the financial metrics. However, you should aim to provide between 250-500 words when answering the Q1-3 above.

That's it for Part 2.
You have now completed the assignment.

Don't forget to submit to Canvas!